

July 9, 2009

## 2009 Second Quarter Review

It is now almost universally accepted that the financial markets have recently made a narrow escape from the edge of the abyss. Massive and unprecedented intervention by the Federal Government seems to have prevented, or at least forestalled, a deepening of the most severe international financial crisis since the Great Depression. The “second derivative” rally from the March 9<sup>th</sup> low carried over into mid-June before beginning to recede. For those of you who remember your calculus, the “first derivative” is the rate of change of Y with respect to X (e.g. speed or rate of decline in earnings). The second derivative is “the rate of change of the rate of change” (i.e. change in speed, or acceleration and deceleration). Signs began to appear in the economy showing that things were still getting worse, but at a slower rate, hence the “second derivative” rally. The rise in prices of financial assets was also variously described as a “relief rally,” a “green shoots rally,” and an “inventory restocking rally.” Reported earnings were surprisingly good, but they were almost all accomplished by cost reduction, in spite of declines in revenue. Whatever the excuse, it was enough to bring stocks back up to around break-even for the year. The Dow Jones Industrial Average finished the quarter down 3.75% for the year, while the broader based S&P 500 edged up to a positive 1.78% showing so far in 2009. Corporate bonds rallied while Treasury bonds fell, as investors began to come to the conclusion that the world was not coming to an end. Evidently, if the world IS coming to an end, you should own Treasury Bonds, but not if the future is survivable.

After such a spirited rally the S&P 500 is at 16 times estimated earnings, which is not historically cheap. Oil rose 40% in the quarter for its best performance since 1990. Unfortunately, unemployment has risen to 9.5%, and would be over 18% calculated the “old” way, according to a U.K. analytical group. Credit card defaults recently topped 10% and office vacancies hit 16%. The stock market may have “gotten ahead of itself” after the rally off the March lows, and has more recently drifted lower since mid-June.

The financial news has calmed somewhat, but the dramas continue to unfold. A record 1,471 hedge funds (15% of the total, according to “Hedge Fund Research”) shut down last year after managers posted record-breaking losses. As it turns out, Mr. Madoff’s clients were not in a very exclusive club after all when it came to losing money in hedge funds. Just this past week, John Merriwether (of Long Term Capital fame) closed his most recent fund after losing 44% in less than two years. This is after his “geniuses” and he lost over 90% of investors’ money in their Long Term Capital fund in 1998. The rescue that the Federal Reserve orchestrated at that time turned out to be a mere training run for the far more massive response recently needed. Evidently, they didn’t listen to Pete Townsend and The Who from their 1971 hit. The Fed along with Merriwether’s investors *did* get fooled again.

A friend of mine who is a former employee of Goldman Sachs recently pointed out to me that we have had two “once in a lifetime” bubbles burst in the last 10 years; the Nasdaq or “Tech Stock” crash of 2000-2002, and our own Grand Recession. According to Pimco’s Bill Gross,

forecasts based on econometric models inevitably miss these secular/structural breaks in historical patterns. Reacting to the changed circumstances has been essential to staying solvent, as opposed to the old “buy and hold” strategy touted by so many Wall Street institutions in order to sell mutual funds and gather assets. “The goal of long term investors is survival.” That quote has appeared in a number of research articles that I’ve read in the past few months. I am thankful for and proud of the fact that we have done just that; survived potentially devastating financial turmoil on more than one occasion in recent years. Now that we are still standing, the task is to determine where we go from here.

We may very well enter a “new normal” that may include slower growth with a bumpy recovery when it does occur. The growth in the economy could slow to 1-2% instead of the 3-4% we’ve been used to. Throughout the economy we are likely to see continued deleveraging (reducing debt), re-regulation, tax increases, and government deficit growth. All of these are headwinds to a general rise in stock prices. The Fed is likely to keep short-term rates low to rescue the banking system from their gorging on leveraged investments that went sour. Unfortunately, this penalizes those of us who have saved cash and would like to get a decent return from it. The “new normal” may produce capital returns below those that investors got used to in the 1990’s and after the tech stock crash of 2000-2002. Instead of a “V” shaped recovery, we may have a “W” (*that would be appropriate*) or even a “square root sign” recovery where the initial rebound flattens out for an extended period (like Japan).

One of the most important questions is whether we are headed for deflation or inflation. Many newsletter writers are touting commodities as a “no brainer,” “sure thing” investment. There is no doubt that, in a cash based economy, printing more money (or ‘quantitative easing’ as it is called these days) is inflationary. But what happens when credit is being destroyed at a faster rate than our central banks are printing money? Or when that money is going to shore up bank balance sheets instead of being lent back into the economy? We may very well see inflation return. I believe it is likely to show up later than most of the “hot money” commodity buyers think. Still, we should be prepared. Inflation? Probably so, but probably not yet.

I tend to agree with Pimco’s Bill Gross, who believes there is a place for commodities and inflation hedges in the portfolio, but that investors should prepare for a slower growing economy by stressing reasonably secure income in their investments. This can be done by buying stable, dividend-paying equities and shorter maturity corporate bonds. Keeping maturities short produces lower income but less risk if interest rates rise. Stocks in companies with the ability to pass cost increases along to customers could do very well even while the market punishes the stocks of those companies who cannot. Inflation may push up the costs of what we use, but perhaps not what we own (e.g. food and materials, but not real estate). Consequently, the composition of investments in portfolios will likely be more important than ever. The “new normal” will likely be bumpy and difficult to navigate, but there will be opportunities for making profits. They just won’t likely be the same ones that worked in the last cycle.

Enclosed you will find your second quarter reports and statements. Please call me at your convenience to review your investments and our strategy for your portfolio. As always, I am grateful for the opportunity to work with you and I hope to continue to earn the privilege.

Sincerely,

Claude Carmichael CFA