



CLARITY ~ SIMPLICITY ~ INDEPENDENCE

August 2009 Newsletter

From where Pete and I sit looking at markets and continued fiscal and monetary policy turmoil we would have never thought that last quarter and year-to-date would have yielded market index returns of Dow +8.18, S&P +12.18, and NASDAQ +25.63. There was so much confusion and concern, the forecasts were horrible, and the most likely outcome was doom and gloom. So what happened? Well, the economic forecast and Wall Street earnings were horrible but the results were a little less horrible than expected. More importantly, opportunistic investors began jumping on sectors that had been significantly oversold such as real estate, emerging markets, financials, and high yield bonds. Many of our strategists have named this phenomenon the “Dash to Trash”.

Our responsibility and challenge is to insulate our investment decisions from the emotions that have clearly overtaken the marketplace. We need to see more significant and compelling reasons to think that this recent rebound has basis and staying power. Price/Earnings ratios, earnings and economic forecasts, plus political unrest and “SWAG” decisions by the Treasury and Federal Reserve are at best based on “unknown territory”.

Our approach at this time has not changed. For those investors looking to recoup their losses, with the tolerance to remain in portfolios highly correlated to the stock markets, they have seen a formidable recovery, but with plenty of work left to be done. For investors more concerned about the integrity of their remaining wealth, willing to accept less upside in exchange for less principal risk, we have made a commitment to more defensive and less correlated investment strategies.

Economic Review Second Quarter 2009

We ended the First Quarter 2009 on a note of cautious optimism, sparked by a strong March rally that lifted the S&P 500 Index to an 8.76%¹ return for the month. That optimism seemed justified as the rally pushed forward during the Second Quarter 2009, with the S&P 500 Index returning 15.9% for the period and posting a 36 % gain since establishing a twelve year low on March 9ⁱⁱ.

Unfortunately, while those robust gains took some of the sting out of the current bear market, the S&P 500 is still well off its September 2008 pre-financial crisis levels – not to mention its October 2007 high. As the rally flattened in June 2009, a number of concerns were raised: Was this a bear market rally, with the slide likely to resume and deepen? Or had the economy and the markets seen genuine signs of recovery? And if we are entering a recovery, how robust will be the market response?

Obviously, only time will tell. Nonetheless, we can sift through some of the data and historical perspectives to get a better grasp of the potential road ahead. Here are a few of the factors we are paying close attention to:

Credit

Credit is enormously important to the U.S. economy, both for business and consumer spending. The U.S. government has committed trillions of dollars to stabilizing banking and the flow of credit and, while challenges remain, liquidity does seem to be returning to the credit markets. Credit spreads have also declined during the quarter, potentially signaling a greater willingness among investors to shift from the comparative safety of government instruments to corporate fixed income securities.

Banking

In May, the Federal Reserve released the results of its stress tests of 19 major banks, and announced that 10 needed to raise additional capitalⁱⁱⁱ – which many did through the sale of non-core assets, issuing new shares, or with the help of the government. The market responded positively to these actions, with the Financials turning in the strongest performance of any S&P 500 sector with a 35.71 % return.

Recovery Signals

We can expect to see mixed signals over the next several months as the economy moves from recession to recovery. Among the positive signs, consumer sentiment and confidence have increased over the second quarter (before dipping again in June)^{iv}, although they remain low in historical terms. Pending home sales have also increased over the three consecutive months^v. Also, surveys of purchasing managers from the Institute for Supply Management, a forward-looking economic indicator, found encouraging trends^{vi}, although they remain at recession levels at quarter end.

On the other hand, rising consumer confidence has not been matched by spending, at least for big ticket items. Vehicle sales have never dipped below the 10 million mark for any month since 1982 – until 2009, when each of the first five months of the year failed to reach 10 million^{vii}. (June numbers are not yet available.) Unemployment also continues to rise^{viii}, with higher-than-expected June figures sparking a sharp sell-off just after the quarter end. While unemployment tends to be a lagging indicator that peaks well after economic growth has been re-established, it may inhibit consumer spending, which in turn may slow recovery.

Recession Forecasts

The end of a recession, like the beginning, is only identified in retrospect. Estimates for when the current recession will end have ranged from the Fed Chairman Ben Bernanke's May 5 testimony^{ix} that the recession might be ending during the Second Quarter 2009, to more cautious estimates that the recession will linger until early 2010.

One optimistic assessment comes from Ned Davis Research, Inc^x, which has tracked a group of 12 indicators, including the S&P 500 Index, nonfarm payrolls, sentiment indicators, credit spreads and others, which they believe have been the most reliable at indicating the end of a recession. As of early June, they reported that all 12 indicators were signaling that the recession had finally bottomed and was moving toward expansion. It goes without saying, of course, that historical comparisons, while suggestive, are not guarantees.

Corrections and Bear Market Rallies

Perhaps the biggest debate among investment managers over the quarter has been regarding the nature of the recent rally. Is this the beginning of a new bull cycle, or is it a bear market rally with new lows to come?

Some bearish commentators look to 1930, when the market (as measured by the Dow Jones Industrial Average) recouped more than a third of the original stock market crash, only to sink drastically lower, reaching a bottom in 1932 that erased over 80% of the previous market highs.

Most commentators, according to our review, lean towards the more positive outlook that we will experience a correction before the up cycle resumes. Ned Davis Research^{xi}, to name one example, conducted a historical analysis of similar bull markets, and their conclusion is that today's cycle most resembles 1974, which saw a shallow - 5.6% correction before the recovery resumed.

Ultimately, what will determine the direction of the market over the remainder of 2009 is the degree of concrete evidence that the economy is indeed recovering. The argument can be made that the market has priced in a third quarter recovery, as well as assumptions about the strength of the recovery. In order for current stock valuations to be sustained, let alone advance, recovery signals will have to become more pronounced. Disappointing economic news may not lead to severely declining prices, but it may leave the market stagnant for months to come.

Looking Ahead

The market rally that began in mid-March was global in scope and brought welcome relief to investors faced with the steepest bear market in decades. The next months are critical as the market seeks to consolidate gains and the economy finds its bearings.

In any market environment, a diversity of asset classes, portfolio strategists and approaches to asset allocation can balance risks and rewards, helping you capture returns with reduced volatility. We look forward to discussing your evolving financial goals, as well as reviewing the mixture of asset allocation approaches within your portfolio, as we seek to keep your investment plan aligned with your needs. As always, we thank you for the trust you have placed in us.

Sincerely,



Thomas K. Ambrose



Peter Blok

Some of the above commentary was provided to us from Genworth Financial Trust Company

ⁱ All Index returns verified on www2.standardandpoors.com unless otherwise indicated.

ⁱⁱ As reported by the Associated Press: http://www.usatoday.com/money/markets/2009-06-30-stocks-tuesday_N.htm

ⁱⁱⁱ <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20090507a1.pdf>

^{iv} <http://www.conference-board.org/economics/ConsumerConfidence.cfm>

^v http://www.realtor.org/press_room/news_releases/2009/07/record_fourth

^{vi} <http://www.ism.ws/ISMReport/MfgROB.cfm>

^{vii} JP Morgan Weekly, Market Insight Series, June 15 2009

^{viii} <http://www.bls.gov/news.release/empsit.nr0.htm>

^{ix} <http://www.federalreserve.gov/newsevents/testimony/bernanke20090505a.htm>

^x Chart of the Day, Ned Davis Research, Inc, June 12 2009

^{xi} Chart of the Day, Ned Davis Research, Inc, June 12 2009