

# March 31, 2009 Market Commentary and Outlook

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*And they all lived happily ever after.*

--The ending to numerous fairy tales, romance novels, works of fiction, and very infrequently, a true story.

Everybody loves a happy ending. And the formula for such “feel good” stories is the same. There is some incredible adversity that needs to be overcome, be it a wicked witch, physical challenge, an evil empire—something seemingly well beyond the control of the story’s hero. The outcome is in doubt throughout most of the story, and the resolution comes in the last chapter, and only after the use of magic, a fortuitous event or some incredible feat of valor.

Right now, we all want a happy ending to what is certainly the most severe economic downturn since the Great Depression. One day, there will be an enthralling book or two written about the tale we all are living. *And will there be a happy ending?*

The Dow Jones Industrial Average started Year 2009 by ending on the year’s first trading day what had been a welcome 6-week rally of nearly 20%. (*The story’s Hero has now been introduced. This was the Obama Rally, Wall Street feeling exuberant over the pending change in leadership in Washington.*) The DJIA then proceeded to fall over 27% through to March 9 as further weakening in the economy becomes evident with such dire economic reports as a larger, negative 4th Quarter Gross Domestic Product, increasing unemployment, continuing declines in housing values, mounting losses at AIG, etc., etc. (*The forces of doom are lined up against our Hero. The Evil Army seems unbeatable!*) The market turns around on March 10 and advances over 22% through to last Friday, April 3, primarily because of two events: Congress passes the American Recovery and Reinvestment Act (ARRA), and the Treasury introduces its Public-Private Investment Program (PPIP) to buy the toxic assets of banks and get them healthy again. (*Our Hero marches out his forces to do battle with the Evil Army.*)

Did Wall Street skip ahead to the end of the story, read the last chapter, see that the economy recovers, and assume that ARRA and PPIP are effective weapons in our fight against the problems of the US and Global economies? Are investors to believe that the forces of doom are vanquished so easily, and our storybook ending is all but inevitable?

A happy ending is a sustained bull market rally. We certainly hope the market is right, but there are many, many chapters yet to read in this current saga of economic woe. And happy endings do not always happen in real life—or at least not so quickly.

Did we see the lows of this bear market on March 9; and has the bull market started? To conclude that the ARRA and PPIP

will work; that the economy will turn around as a result; and that the bull market has started is optimism in its purest form. **Investors should remain skeptical and be worried that we are simply in a “bear market rally.”** Since October 10, 2008, the market has, on three separate occasions, advanced 20% or more, only to fizzle out the first two times and give up all of those gains and eventually establish new lows. Will this recent rally be any different? Remember, bear market rallies are commonplace events.

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We have been reading many excellent commentaries severely criticizing the PPIP. We think investors should read these carefully, and if you agree with their assessment, contact your Congressman and express your opposition. The PPIP proposes that the Treasury partner 50/50 with a select group of entities (mostly banks and hedge funds) to buy the toxic assets of banks where the bulk of the purchase price is a non-recourse loan from the FDIC. In other words, the private, chosen few put up seven cents on the dollar and we, the taxpayer via the Treasury and the FDIC, are on the hook for the balance of the purchase price on these toxic assets from banks. If there is a profit, it will be split 50/50 with the U.S. Treasury (indirectly, the tax payer). If there is a loss? Well, the taxpayer’s “private partner” only has its 7% at stake. You do the math.

Because the banks can set up “special purpose entities” to purchase these assets from themselves or other banks (using borrowed money from the Treasury to put up their seven cents on the dollar of the investment), profits of the banks in the near term might look terrific. (Such manipulations would make Enron’s financial officers blush!) Wall Street’s response will most likely be positive—particularly given last week’s relaxation of “mark-to-market” accounting rules by the Financial Accounting Standards Board (FASB). These new rules will allow our nation’s financial companies to use more discretion in the way in which they assess the fair value of their toxic assets. Are they likely to abuse this and mark up assets higher than they are worth, thus improving their balance sheets? Not these guys! Remember how good their assumptions were when they created their pricing models for buying those toxic assets in the first place.

Yes, there could be some immediate improvement in the balance sheets of financial institutions as they dress up their Tier 1 capital reserves and stave off some regulatory action. But we liken this accounting wizardry to putting dirty pots and pans in the oven when scrambling to clean up the kitchen for company that is showing up unexpectedly. The kitchen may look clean, but the pots and pans still need to be washed.

We believe that ARRA was necessary legislation to help “prime the carburetor” of the U.S. economy. It is, however, insufficient fuel to keep the engine running. Consumer

spending is that fuel. We find it curious that part of the solution to our economic problems is to get the consumer borrowing money again and to spend, spend, spend. Aren't excessive leverage and spending some of the problems that got us into this mess to begin with? *But we need to get the banks lending again!* Does the average consumer want to borrow money now? With unemployment rising, is the average U.S. consumer not a tad bit nervous? Has the consumer not learned a painful lesson about excessive leverage? Will banks even lend to the average consumer, instead imposing strict albeit prudent lending standards they had foregone years ago?

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The market has a way of making one look foolish, and what appears to be window dressing and accounting sleight of hand to us may turn about to be real magic. Of one thing we are quite certain: Current monetary and fiscal policy will result in huge amounts of debt being carried by the U.S. Government, either by the Treasury or the Federal Reserve. Ultimately, that debt service will be a significant drag on the U.S. consumer, corporations and the economy. It will be highly inflationary. Longer-term interest rates will rise. The value of the U.S. Dollar will weaken against other currencies.

These predictions might play out in a few months or a few years. One should not sell short the creativity of our policy makers, the staying power of the Treasury and the Federal Reserve, or the global "flight to quality" that could persist.

Inflation and currency devaluation are, however, long-term investment themes that can be pursued. We continue to recommend avoiding long-term bond maturities and to invest in inflation-sensitive securities, especially natural resources.

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We cannot deny that the financial markets are forward looking. For the market to rally on the belief that fiscal and monetary policy will prove effective is to be expected. In 11 of the past 12 recessions, the markets forecasted the end of the recession and started its bull market rise months before the economy actually did improve. Not a perfect record, but a pretty good record, one which investors need to be cognizant of. We think that when the market does start its bull run (and it may very well already have started), it will be a "violent recovery." By this we mean, the increase in prices will be quite dramatic in the early stage of the bull market.

Even with this third rally, we are still back to where the DJIA traded last year on November 19, 2008. Looking back even further to a bull market peak in March of 2000, the value of the S&P 500 was 1.13 times the GDP of the U.S. In other words, you would have to write a very big check to buy all the shares of all the companies in the S&P 500. This past Friday, the valuation of the S&P 500 was only 51.5% of GDP (assuming GDP shrank by 1% YTD)—a much smaller check. Despite the recession, the recent decline in GDP is not anywhere close to what the decline in the S&P 500 has been over the past 16 months. Stocks look cheap on a relative basis using these metrics.

No matter how cheap stocks appear, that doesn't mean they can't get cheaper yet. And they have, as we saw in early March. Keep in mind that the low valuation of stocks is relative to a bull market in which stocks were significantly overpriced.

While stocks have been getting cheaper, money market balances have been increasing. Two years ago, there was \$2.4 trillion in money market funds. Today there is about \$3.8 trillion in money market fund balances, all of which is earning an extremely low rate of return. What if only 20% of that money came back into the stock market? How "violent" would stock prices be bid up?

We have consistently said commentary after commentary that investors need to get their asset allocation "correct." By this we mean, keep invested in the stock market only that percentage of your portfolio you can afford to have at risk for upwards of a ten year period of time. And be certain you have the temperament to maintain that investment when the markets get ugly as they have over the past 18 months. The alternative strategy is a risky venture: Time the markets and move from cash back into stocks at some low valuation. If we are correct that the next bull market will begin with a "violent recovery," then being overweight to cash from what otherwise is a "correct" allocation could cause you to miss some significant price increases.

But what happens to your stock investments if the market goes lower from here? Remember back in 2007 when the market kept going up and up? How thrilled were you then about owning stocks? Ironically, that's when the risk of the market was the greatest. The incremental returns investors earn at the end of a bull market are almost never permanent. You lose these gains quickly in the very early stages of a bear market.

But in the trough of a bear market should the market decline further as many investors fear, subsequent losses are generally temporary. These losses are the first losses that are recouped. If your asset allocation is "correct" and you have at risk that percentage of your portfolio you can comfortably have in the stock market, then when the bull market does start, you will participate.

And you won't have to read chapters ahead to see what the ending is before being confident in pursuing this strategy.

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