

September 30, 2009 Market Commentary and Outlook

*The phoenix hope, can wing her way
through the desert skies, and still defying
fortune's spite, revive from ashes and rise*

Miguel de Cervantes Saavedra
Spanish author of the masterwork 'El
quijote', 1547-1616

If you're looking for an example of a phoenix reviving and rising from the ashes (other than in a Harry Potter movie), look no further than to the financial markets since March of this year. In one of the strongest rallies from a market crash, the S&P, for example, rallied from a low of 666 on March 6 to a high of 1080 (a 62% gain!) in 6 short months. (At the September 30 quarter end, the S&P 500 closed at 1057.) Foreign markets around the world enjoyed some even stronger advances, particularly when converted into U.S. currency.

Are we at the start of a sustained bull market? Or are the markets overbought, overvalued, and supported by unjustified bullish sentiment?

The bullish investors will argue that we have seen the market lows, and most bears also will concede that the odds are we have. This, however, does not infer that there will be no meaningful pullback in asset prices, or that the markets will continue a sustainable climb in prices. Other post-crash markets have seen advances as large, or larger, than we have enjoyed since March, only to be followed by significant, if not devastating, price declines. At best, sustained market advances are frequently interspersed by profit taking and corresponding (albeit temporary) lower stock prices. Post-crash markets frequently include partial recoveries that are followed by extended periods of sideways price movement. To expect the stock market to behave differently given the cause of the recent market crash, to assume that the economic recovery which many are forecasting will behave just like the typical post-World War II recovery and everything is back to normal, is, in short, a belief in the mythical phoenix.

How much can we infer from the performance of the equity markets about the health of the US Economy? The consensus is that the US Economy has bottomed and will enjoy a rise in GDP in perhaps the 3rd if not 4th

Quarter of 2009. GDP growth will steadily continue to rise throughout 2010, and by 2011, GDP growth will be above 4%.

Investors believe that stock performance often foreshadows economic strength by three to six months. To date, investors have viewed the existence of actual, convincing evidence of economic strength as dispensable; "less bad" economic news is good enough. Past economic recoveries typically have been very forceful in generating clear evidence of real economic improvement immediately following the economic low. If the optimists are correct, we should start seeing some positive economic data over the course of the 4th Quarter.

(There is the contingent of economists forecasting a "double dip", meaning the economy will slide back into recession after a quarter or two of sub-par growth.)

On what basis are investors so optimistic about an economic recovery, particularly in the teeth of rising unemployment and increasing mortgage defaults and foreclosures? The answer is simple: government stimulus. Pump enough money into the economy—however misdirected you might consider it—and there's likely to be some positive effect. The response to the financial crisis was very quick, global in nature, and certainly larger in degree than any previous efforts. The effect of this stimulus was sufficient catalyst to move the markets higher, from this bear market's lows (to date). **But is government stimulus sufficient to jump start the economy? Or will intrinsic economic activity remain weak (or even weaker when government stimulus inevitably ends?)**

Prior economic recoveries have been fueled by an increase in debt-financed activity such as housing starts, capital spending, and sustained automotive demand (not just a brief "Cash for Clunkers" jolt). Economic fundamentals deteriorating at a slower pace is not sufficient to support the idea of a recovery; real economic growth is needed. A tall order when unemployment continues to rise, real wages are falling, and credit continues to be difficult, if not impossible, to be had. (This is especially bad for small business, reported to employ half of the workforce and representing about 35% of GDP)

Bank stocks have rallied considerably since March. Justification of their continuing health has to overcome two hurdles. First, there has been a lull in the reset schedule of adjustable rate mortgage (ARMs) since March. Unfortunately, we are at the beginning of another wave of resets to Alt-A (Liar Loans) and Option-ARM mortgages which will extend through 2010 and into 2011. Most of these loans were taken out late in the housing boom cycle, meaning these houses were purchased at the highest prices and will have suffered the greatest percentage drop in value, leaving most of them with negative equity. Expect another wave of defaults and foreclosures over the next two years—a trend that is currently beginning.

The second hurdle to surmount has come about from the relaxation of accounting rules earlier this year that allowed banks to ignore increasing loan and portfolio losses. Can such recognition of losses be postponed if defaults and foreclosures are increasing? If not, this could set off another round of bank write-offs. The market would not greet such news positively.

On Friday, October 2, the Bureau of Labor Statistics reported a new estimate of job losses: During the 12 months ending this past March, the economy lost 5.6 million jobs—824,000 more than the 4.8 million previously reported. Expect to see a report showing there were 130.1 million civilian jobs in the economy in September (8 million jobs, or 5.8%, below the peak reached as the recession began in December 2007).

Initial estimates of job losses in the first half of 2008 (when the recession was well under way) apparently were understated. Losses averaged 146,000 per month—nearly three times the average of 49,000 initially reported.

Such a swing in estimates is not surprising given that official job numbers are based on a monthly survey of employers and adjusted by the “birth-death model.” This model is akin to balancing your checkbook mid-month and making some adjustments for all of the ATM withdrawals you failed to write down in your check register. The Bureau assumes there are a number of jobs created by new employers not included in the

survey, while jobs were also lost by those employers who did not respond to the survey (only because they failed in business.) How significant is the model’s contribution? For the 12 months ending March of this year, the model added 717,000 jobs to the survey results! The Bureau recently instituted what is referred to as a “benchmark revision,” i.e., a change in the birth-death model. Thus, the big revision in the employment numbers reported on October 2.

So the unemployment rate at 9.8%, plus or minus a small fudge factor. No respectable economist (is that an oxymoron?) is forecasting a near-term decline in unemployment. To the contrary, unemployment is expected to climb above 10%. Even Fed Chairman Bernanke concedes that point. Increasing economic activity in the near-term will not result in an increase in employment. Employers will first turn to existing employees who on average are only working a 33-hour week. It’s more efficient, practical and cheaper to increase their hours than hire on new employees. Why is this significant?

71% of economic activity is attributable to consumer spending. The unemployed, those concerned about job stability; those with a cut-back in hours, won’t spend money like the average consumer did pre-recession. If they don’t spend money, businesses can’t sell goods and services, and they become cautious in their capital spending. The growth in the economy slows.

Investors need to remain cautious despite the recent increase in the stock markets. Certainly one lesson learned over the past year is that while financial markets are resilient, they can at times be very treacherous. The more important lesson is that the markets can move very quickly, both up and down. Your portfolio should reflect an asset allocation that you can tolerate for the long-term.

Northwest Capital Management, Inc.
October 5, 2009

Past performance is no guarantee of future results. This article has been distributed for educational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. Opinions are subject to change without notice. Northwest Capital Management, Inc. ©2009