

December 31, 2009 Market Commentary and Outlook

"If only we could pull out our brain and use only our eyes"

-- Pablo Picasso

With 2009's 26% increase in the value of the S&P 500, investors who remained in the market have much to celebrate. While 2009 was far above average in terms of growth for the S&P 500 (and the 4th Quarter's 6% increase helped cap a great year), the "lucky" long-term investors in the S&P 500 index are just getting back to even. This past quarter's closing price was the same as it was in July 2004. How many of us complained that money markets were returning a zero percent rate of return for much of 2009? How about a nearly zero percent return over the past 5-plus years in the S&P 500? Sure beats the negative return most have experienced since the market peaked in October 2007! Better to keep our brains intact and focus in on the improvement in the markets over the past 9 months.

OK, so we as investors have some ground to make up here in 2010 given that the market is at the level it was nearly six years ago. Coincidentally, many investors feel their retirement plans have been set back a corresponding number of years. One big difference between 2004 and now is that a postage stamp is no longer 37 cents, and it would be impossible to find a 25-gallon tank of gas for \$55. By these quick measures prices have increased between 13%-19% since 2004 (stamps are now 44 cents, and a 25-gallon tank of gas is around \$70 in Oregon and Washington). Official data from the US Bureau of Labor Statistics indicates that \$1.00 buys about 14% less today than it would buy in 2004. No matter which inflation number you use, the negative impact of inflation on the purchasing power of a dollar is discouraging given the poor, longer-term performance of the S&P 500—particularly since a primary reason for investing in stocks is for its hedge against inflation.

Let's not forget that today's equity market levels are still a welcome change from March 2009's intraday market low of 666. What we saw in the last 3 quarters of 2009 was nothing short of remarkable: The first time the S&P registered at 666 was in September 1996. The next time it was at 1115 was eight years later in September 2004. (We saw 1115 again in 2008 but that was when the market was in a nosedive). Roughly speaking, we've made over 8 years' progress in three calendar quarters despite a negative economic environment! The obvious question many find themselves asking is, "What is the outlook over the coming 12 months?" and "What may the current rally mean for an economic recovery?"

Economic Strength Looks Like an Illusion. Seemingly several measures of market health have improved. The stock market has rallied, corporate bond investors are now pricing in just a fraction of the default risk for large companies that they did just one year ago, and market volatility has restored itself to levels typical before the financial crisis. It's tempting to look at these observations and conclude a strong 2010 is a near-certainty. But that would be following Picasso's advice too closely.

These developments are more difficult to interpret because the financial world has become much more complicated over the last year. For example, note the existence of a slew of government programs including TARP, PPIP, TALF and others aimed at restoring health to the financial system. Nearly all of 2009's positive growth in the financial markets is directly attributable to the actions of the Federal Reserve and Treasury. Since these measures are not naturally-occurring, many would argue that the predictive power of the recent market rally isn't quite as strong as it used to be. And what happens when the Fed withdraws this stimulus (which it is sure to do)?

The Chicken or the Egg? While the government was aggressively injecting liquidity into the financial markets, the values of some assets (equities) have increased, while several others have lost value over the last year (the dollar, homes). It's a unique development and involves questions like: "Where's the money going?" and "What's being done with it?" Much of this liquidity creation has landed—and remains—on bank balance sheets, and returned to some areas of the capital markets, but not to the consumer. So recent stock price increases are exciting, and the market in hindsight was certainly oversold given the eventual stability Fed policy brought back to the financial system. But if consumers are not buying products from a company, how is it that an investor can expect future growth in that company's stock price (let alone to maintain its current valuation)? This is the fundamental question we're facing. Without improving the unemployment situation and increasing access to loans for small businesses and consumers, it's difficult to forecast sustainable economic growth. As a result, we do not foresee strong improvements in fundamentals over the next few quarters.

High unemployment figures, while undesirable, have a positive side-effect. Some posit that US companies are better-positioned to grow earnings than their European counterparts since US companies have smaller expense lines (and are learning to do more with less). Once earnings return, there should be an increase in justification

for upward movements in share prices. Unfortunately, nobody knows when this may happen. While the US is well-positioned against the European Union in terms of economic growth (about 1-2% for the US, closer to 1% for Europe), the world's GDP growth stories of 2010 may likely be the domain of Brazil, Russia, India and China. Morgan Stanley estimates growth rates in GDP for these nations of 5.8%, 5.3%, 8% and 10% respectively.

The Financial Sector & Housing Exposure While US growth prospects are better than those of the EU, many analysts expect the first quarter of 2010 to see earnings significantly below par for the financial sector amid concerns of additional waves of mortgage defaults and revisions in accounting rules. New accounting rules would require that poor performing assets be reported on balance sheets (and weigh against earnings). Additional waves of mortgage defaults in the financial sector can result in an increasing reluctance of banks to lend. Without access to ready lines of credit, small businesses cannot grow.

When loans stop performing, a bank's capital adequacy ratios decrease, and regulators prevent the bank from issuing new loans until cash can be raised from shareholders, by asset sales, retail depositors or lately, through government cash infusions. The fear is that an additional round of loan defaults could set off a second credit crisis. How would it be dealt with this time? Shareholders are tired of additional rounds of equity infusions to banks. And taxpayers are increasingly resistant to back additional government bailouts. Banks still need to work through the remnants of the last credit crisis in an environment where some estimate one in every ten home mortgages is delinquent, and the outlook for commercial real estate loans is particularly bleak.

Two areas of potential issue in 2010 include Alt-A Loans and Option-ARMs, which have a large wave of reset dates in the coming year.¹ One analysis indicates that many Option-ARM and Alt-A borrowers had already defaulted long before their reset date. So how big a problem is this for a US mortgage market totaling \$10.3 trillion, and one in which perhaps as much as 50% of all homes have zero or negative equity? These are economic factors that we can not ignore, and are not insignificant barriers to recovery.

What's a fellow to do? If you are an unemployed home owner with negative home equity, do you remain unemployed and continue looking for work locally (imagine this in Detroit!); or do you undertake a "strategic

default", give your house back to the bank, and re-locate elsewhere for a new job? Is there any difference in the economic effect on this individual finding a job and defaulting on his mortgage versus remaining unemployed in hopes of finding a job before losing his home? This dilemma is faced by millions of unemployed homeowners and does not bode well for banks in either case.

The strategic default issue is an additional concern for banks. Increasingly, qualified borrowers who can afford their mortgage payments but who have negative equity are considering the option of allowing banks to foreclose on their homes. The strategic defaulter's plan is to continue working, but to make smaller payments as a renter in a different property. Fortunately (for banks anyways) studies indicate that a disproportionate number of Americans are keeping their homes rather than suffer the indignity of foreclosure (yet). If attitudes change more quickly than home values improve however, banks may face issues of compounding seriousness.

So despite a strong rally in equities markets over the last three quarters, it remains difficult to see significant improvements in the economy. Investors should continue to focus on limiting their risk to a level appropriate for their circumstance. Budget deficits, stubborn unemployment, and possibly rising interest rates will make investing challenging in the near term despite illusions to the contrary.

Just as investors learned that losses at market bottoms prove to be temporary and are readily recouped in the earlier stages of a market rally, losses that occur at market tops are somewhat permanent—or it can take years to get back to even. Be careful in committing new money into a protracted bull market when the stability of the economy is so difficult to see.

Let's hope for a strong economic recovery and avoid following Picasso's advice too closely. 2010 will require careful, thoughtful investment oversight as we position for a very volatile economic recovery.

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¹ A reset date is a pre-arranged increase in payments. Alt-A loans are between 'prime' and 'subprime.' Option-ARMs feature resets based on adjustable rates and can feature negative amortization where the loan principal becomes increasingly larger.