

March 31, 2010 Market Commentary and Outlook

[For] "some foreign policy problems, the answer is to kick the can down the road and wait for them to get better and hope time takes care of them."

President Bill Clinton, speaking on his efforts to resolve Middle East problems

Since the markets touched their lows roughly a year ago, investors and financial professionals alike have drastically changed their tunes. Back then draconian subjects like bank nationalization and automaker bankruptcy were being discussed daily. Now discussion has shifted to mundane topics like how next quarter's earnings will pan out; if the Fed will raise rates by 25 or 50 basis points; how much did inventory restocking contribute to GDP, etc. Compared to financial busts like the Great Depression, the Japanese crash, or the Savings and Loan crisis, recent market action has seemingly resulted in a relatively comfortable soft landing!

With an estimated \$16.4 trillion, or 113% of the U.S. Gross Domestic Product, willing to be committed, and \$3.26 trillion actually having been spent by the U.S. Government to restore confidence in financial systems, it's no wonder there was a short-term recovery in markets. Although an unprecedented amount of support has been provided for the U.S. economy, but with no real long-term solutions having emerged to create jobs and a stable currency, panic has dissipated from markets. The market has reacted as though our financial system has successfully cleansed itself, and earnings estimates suggest a speedy return to normalcy. Have the risks to our financial system really been solved so quickly? Are there no more risks in the foreseeable future? Are we really in the clear? Or has U.S. monetary policy simply kicked the proverbial "can" down the road, hoping time takes care of the problems that almost caused Financial Armageddon a little over a year ago?

Investors who are in a defensive position are finding it excruciatingly more difficult to remain skeptical about an economic turnaround. Many argue that the stock market can be characterized as overvalued by historical measures. Sentiment is overwhelmingly bullish while yields for conservative fixed income investments are seen as unattractive given their very low rates. Risk taking has been encouraged and rewarded! Say what you will about the risk in the market, such markets do have a tendency to trend higher albeit with marginal new highs. They tend to

pull back by a few percentage points, only to recover that lost ground and achieve minor but widely celebrated new highs. Historically, such markets do ultimately experience nearly vertical drops, frequently over 10% during a few weeks period of time. Such a decline appeared to start in January, but as we had observed back in 2007, the market quickly recovered and new highs were established. Given the resiliency of the markets, and investors' complacency, one must ask, "Is this market really overvalued and overbought?"

We think so. We think the can has been kicked down the road. As anyone who has kicked the literal can down a dirt road, there is the ability to keep the can from going off into the ditch for long periods of time. Will U.S. fiscal and monetary policy be as proficient a kicker?

The S&P 500 rallied 71% from its intra-day low of 666 on March 6, 2009 to closing at 1138 on March 5, 2010. It is no secret that markets can act irrational over a short period of time, as many attributed the March lows to be an over-exaggerated plunge. The issue of 666 being fair value on March 6, 2009 is not what we, as investors, are concerned about now. The real question is how might it react going forward? With a plethora of economic risks (a potential second-wave commercial real estate credit crisis, a residential real estate market that is not improving, and decreasing political capital to enact a second-round of stimulus) lined up in front of a market that does not seem to acknowledge them, is it possible for the market to continue rallying into 2011 as government stimulus fades and the Federal Reserve withdraws its support of the housing market? Ignoring market fundamentals may cause the market to continue up for a while longer by sweeping these risks under the rug, but these issues will pile up as they did in 2007 and 2008 when not dealt with. This would not be the first time policymakers turned their heads on risks in the real estate sector; we quote Fed Chairman Ben Bernanke in 2007: "*We believe the effect of the troubles in the subprime sector on the broader housing market will be limited and we do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system.*" Markets reacted and concurred with this statement, but we as investors know what happened next in Fall, 2008.

Markets have once again reacted in 2009 and 2010 as though these risks have been addressed and will be contained. Some allude to market movements as a swinging pendulum: if markets overshot the downside, why couldn't we overshoot the upside? We believe increasing your risk exposure now would be chasing a relatively small return for large amounts of future risk. This is a difficult time for investors as panic has subsided and markets have rebounded dramatically, but uncertainty remains on many levels. As of the April 7 close, the S&P 500 was still down -24% from its end of day peak on October 7, 2007; but the impact of the recent global economic financial crisis on financial systems around the world has been enormous and some would say things may never be the same. With the market environment in this condition investors must look towards their personal risk tolerance when deciding how to pursue investing. The way in which an investor combats this market outlook depends on how large losses in a short period of time interact with their retirement goals in the context of their investment horizon.

We believe that we are now at a point where market valuations are less attractive due to the run-up, and that financial market risks are rising. For now we have to allocate cautiously and watch for problems to unfold; but eventually we should be at a point where we have greater clarity on the economic outlook and more attractive stock valuations as the global economy once again fires on all cylinders. As market risks work their way through the system, we expect to shift to a more optimistic market outlook. So what would we buy? In stocks, as long-term investment themes we favor companies involved in natural resources, emerging markets, and those that can tap into growth within emerging markets, such as large multinational corporations. For the time being our stock investments are tilted towards conservative, flexible, stock-picker managers and large cap funds. Within bonds we are primarily invested in conservative, income-oriented, low-duration US managers and high caliber global bond managers to take advantage of foreign market opportunities.

The risks the economy faces are not fully reflected in the current market and do not appear to be short-term in nature. Despite a strong 2009 performance for stocks (the S&P 500 advanced 26.5%!), systemic risks are building. We're not sure if or when these risks will start to seriously hurt our financial system, but we think that entering the market at this time is akin to a short-term trade: money can be made, but long-term investors risk the brunt of another wave of credit problems and the stress it will put on our banks. While we are not avoiding stocks entirely, we are avoiding investing aggressively at this time.

Certainly the opportunity costs of missing out on a bull market can be high. If the markets rally continues in 2010 as it did in 2009, investors could leave another 26% increase or more on the table--which is no small amount to forego in terms of an investor's retirement savings. These decisions are tough ones, and as we saw during two very recent bubbles (the tech bubble and the housing bubble) market irrationality can be sustained for a long time. Nobody likes to miss a good party, but these are high-stakes decisions when you consider that these are your retirement dollars at risk.

The decisions to be made are difficult ones, and given the seriousness of the situation, we suggest you review your allocation carefully. Call us if you want to discuss your holdings or specific situation. Our own sense is that the market has gotten ahead of itself and our financial system is awaiting another round of problems, making a conservative risk allocation more suitable in our opinion. At least, that's how we are allocating investments within the model portfolios we manage for your retirement plan.

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