

2nd Quarter 2009 Market Review

As of June 30, 2009 the Standard and Poor's 500 index was up 1.8% year-to-date, but down 28.5% from one year ago. I would like to summarize where the markets stand mid-year.

Overview

The second quarter of 2009 was a strong 'bounce' from the carnage of 2008 and the first quarter of 2009. In fact, it was the best quarterly advance for the Dow Jones Industrials since the fourth quarter of 2003. The S&P 500 had its best performance since a 21% gain in the fourth quarter of 1998. Please review the following:

Index	2nd Quarter	Year-to-Date
Standard and Poor's 500	15.22%	1.78%
Dow Jones Industrials	11.00%	-3.80%
Wilshire 5000	16.20%	3.70%
Russell 2000	20.70%	2.65%
Morgan Stanley EAFE	25.40%	7.90%
Lehman Bros. US Aggregate Bond	2.00%	2.10%

Despite a strong quarter, due to the market drop of 57.7% from its high on October 11, 2007 to its recent low on March 6, 2009, and the three bear market years of 2000-2002; the 3, 5 and even 10-year averages are mostly negative for the major indices. The S&P 500's 10-year average through June 30, 2009 is a negative 3.77% annually. On a larger scale the S&P 500 over a 20-year period returned more than 8% per year and coincidentally the U.S. stock market has an 8.76% annualized return from January 1, 1871 through the end of last year!¹

It is interesting to note the financial sector of the market (including banks and brokerages) – one of the hardest hit over the last year – rose 35% for the quarter, though they are still down over 60% from their 2007 peak.²

The commodity market is strengthening while the U.S. dollar is showing some weakness especially compared to the Japanese Yen (+6.16% year-to-date). Crude oil as of June 30th was priced at \$69.89/barrel up 56.7% year-to-date. Gold at \$927.10 per troy ounce was up 4.92%.

Interest rates remain historically low, especially the shorter maturities such as the 13-week Treasury bill with a yield of 0.18%. The 10-year Treasury rate closed the quarter with a 3.5% yield up from 2.6% as of March 31st.

Emerging markets, along with home builders and financials, suffered the most last year. However, during the second quarter we saw this sector snap back with dramatic gains. In U.S. dollars Indian stocks rose 62.9% and the small Sri Lankan market rose 74.2%. The Chinese stock market rose 36.1%. Even the Pakistani market showed a 3% gain. As a group Latin American markets, as measured by mutual funds, rose 45.3% for the quarter³.

Domestically, the strongest sectors were paper, +98.4%, automobiles, +85.6%, tires, +84.8%, real estate services, +76.1% and hotel and lodging REITS, +74.4%⁴.

Outlook

Recently reported, the Conference Board's Leading Economic Index surged 1.2% in May after a 1.1% jump in April, the first back-to-back monthly gains for the index of more than 1% since the 1900s⁵.

June 24th, the Commerce Department said that demand for durable goods rose 1.8% for May, far better than the 0.6% decline that economists had expected⁶. The Commerce Department also reported the U.S. personal savings rate climbed 0.9% in May⁷. In 2008 the personal savings rate realized a 1.8% increase followed by a 4.2% increase in the first quarter.

Businesses, since the September financial meltdown, have been in a cost-cutting frenzy, looking to protect profitability and bolster balance sheets. Unfortunately, as we see it now, businesses have little confidence to expand production and hiring, and this frugality is a current economic negative. Businesses slashed payrolls by 6.2 million workers through May and furthermore, cut capital spending by \$248 billion and inventories by \$294 billion⁸.

As mentioned earlier, there are some positive reports, or as Washington insiders would say "green shoots" in the economy. The result of the current business cycle is that when the recovery really does get going, companies will be very lean, financially fit, and ready to expand operations to their benefit and for the economy.

As of May, households have pushed their savings rates to the highest level in more than 15 years. The Commerce Department reported that consumer spending rose 0.3% but personal income rose 1.4%, the biggest gain in a year. The savings rate surged to 6.9% currently from zero at the beginning of this year⁹. The U.S. savings rate was negative from

2005 through 2007 during the economic boom with Americans spending what they earned and borrowing against their assets including rising values of real estate.

What I believe we are witnessing is what David Brooks described in a recent New York Times article titled, “The great unwinding from America’s financial tangle¹⁰.” In this article he states that our country has grown and prospered on a “growing wave of debt.” The ratio of debt to personal disposable income was 55% in 1960. Since then, it has more than doubled, reaching 133% in 2007¹¹. Total credit market debt – including corporate, financial (CMOs, etc) – has surged from 143% of GDP in 1951 to 350% of GDP as of last year¹². The debt has been the primary fuel for consumption which drives our economy.

This consumption binge also has global ramifications. Consumer spending as a share of GDP was about 62% in the 1960s and rose to about 73% by 2008¹³. As a result, the various international trading partners of the U.S. including China, Japan and Europe became overly reliant on the U.S. consumer. What James Cooper and other economists are saying is that we are witnessing a paradigm shift in our economy where other factors will carry greater weight relative to consumers, such as investment, innovation and manufacturing. A politically correct word for this process is called “deleveraging.”

The current situation is very fragile. Deficit spending by the federal government has jumped from 1.2% of GDP in 2007 to 13% currently. This does not include proposed or pending legislation such as cap-in-trade energy and health care. These are some of the primary issues why investment attitude, even after the substantial bounce in the stock market, remains very tentative and “bearish.”

We do see a few other “green shoots” such as a number of major banks recently passing the Washington ‘stress tests’ by raising over \$74.6 billion required by the tests and 10 banks have begun to repay the federal government money borrowed through the TARP legislation. We see liquidity in the banking system beginning to improve, especially in the overnight lending between banks domestic as well as with foreign banks.

The Corporate bond market is normalizing therefore yields are falling as corporate bond prices rise. The spread between high grade corporate yields and U.S. Treasuries is narrowing.

Late June, the government reported that the GDP shrank by 5.5% in the first quarter of this year, slightly less than the 5.7% decline expected. This is an improvement from the 6.3% drop in GDP for the last quarter of 2008. Many economists are expecting a GDP drop for the second quarter of 2009 of about 2%, and then anticipate some economic growth showing in the reports for the third and fourth quarter of this year – signaling an end to the

recession that began in the fourth quarter of 2007. We believe the recovery will be subdued due to the unemployment rate approaching 10% or higher and the anticipated increases in various tax rates to help pay for the federal deficit spending.

A final factor in our opinion for a subdued recovery which is underway is the problem related to the residential and commercial real estate markets. We feel home prices nationally will need to stabilize if an estimated and sustainable stock market rally is to occur. For the two-thirds of American families who own their homes, a house is their biggest asset. The lower home prices go, the less wealthy these families are and the less likely they are to spend, borrow or invest in the stock or bond markets. Also the lower the home prices fall, the less we expect home builders to build, and the fewer workers they will hire. According to the National Association of Realtors the median sale price of an existing single-family home in May was \$172,000 which was 16% lower than a year ago¹⁴.

One last observation ...The Chinese stock market and many of the European and Asian markets are now positive year-to-date. Historically international markets follow the trend of U.S. markets – but not this time. Currently the emerging securities of China, India, Latin America, etc. account for a third of nominal GDP on a worldwide basis and significantly more than that on a purchasing power basis¹⁵. We believe that the rapidly increasing productivity, development and economic growth internationally, especially in developing countries creates a benefit for American companies that emphasize exports worldwide and will benefit our markets through increasing capital commitments here in our economy.

In conclusion we anticipate the U.S. economy will make erratic progress during the last half of 2009. For substantial recovery to ensue we will watch for stability and hopefully increasing prices in housing. Ultimately rising equity markets will reflect growing economic activity and profit. With second quarter corporate earnings currently being reported we will be diligent and act accordingly for your benefit.

As previously mentioned, from the lows of March 6, 2009 where the Standard and Poor's 500 closed at 666 – a 57% drop from its October 11, 2007 intraday high, we anticipate recovery going forward. This is an opportunity to take advantage of.

Sincerely yours,

George Gumbiner
President

Footnotes:

- ¹ CAGR of the Stock Market: Annualized Returns of the S&P 500 www.moneychimp.com
- ² The Washington Post, Stocks Post Gains for Second Quarter, July 1 2009
- ³ The Wall Street Journal, U.S. Stock Funds Are Left in the Dust, July 2, 2009 page C9
- ⁴ The Wall Street Journal, Quarterly Market Review, July 1, 2009 page C8
- ⁵ Personal Finance, Marketwatch July 8, 2009 page 1
- ⁶ www.realclearmarkets.com, “Durable goods orders rise” June 24, 2009
- ⁷ Investors Business Daily, “Savings Bounce May Be Upside to Downturn,” July 5, 2009 page A11
- ⁸ Businessweek, “All This Austerity Will Pay Off,” James C. Cooper, July 13, 2009 page 20
- ⁹ www.msnbc.com, “Americans Saving More, Spending Moderately,” June 26, 2009
- ¹⁰ The Denver Post, “The Great Unwinding From American’s Financial Tangle,” David Brooks, June 20, 2009 page 11B
- ¹¹ ibid
- ¹² ibid
- ¹³ ibid
- ¹⁴ The Wall Street Journal, “Economy Can Rebound Only When Housing Prices Do,” David Wessel, June 25, 2009 page A2
- ¹⁵ Oppenheimer Funds, Interview with Justin Leverenz CFA, June 17, 2009 page 1