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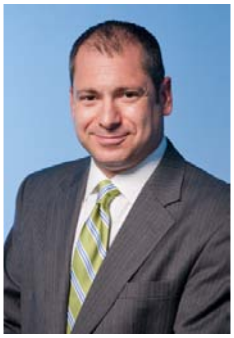

Written by Mitchell O. Goldberg, January 22, 2009.
ClientFirst Strategy, Inc.
For immediate release.

Just when you thought it was safe to get back in the water…

Is 2009 going to be a replay of 2008?

No, but the expected economic recovery in the second half of 2009 is being pushed into 2010. And this is why that nice little rally we just had from 12/23/08 to /1/05/2009 faded away into oblivion.

Market **advances** and **declines** work like this: As the economic recovery is perceived as being closer, the stock market will rally. As the economic recovery is perceived as being further away, the impetus for the rally disappears and the stock market will sink. So, that is the simplified but reliable reason for the ups and downs in the market.

The reason behind the recent optimism was that the U.S. banking sector was beyond the middle of its problems. Due to recent revelations from Citigroup, Bank of America, and other financial services heavyweights, we're now talking openly about nationalizing the U.S. banking system. Oh, what a difference just two weeks can make! Essentially, investors bet prematurely at the end of 2008 that the U.S. banking sector was on its way to recovery. Now, the problem is that we have no idea how to gauge the true extent of what the potential bank liabilities really are, nor would anyone trust the banks' own estimates.

The root of the recession over the last 14 months is the massive deleveraging taking place. This will be the single biggest headwind facing the global economy for years to come. To put it in a number, U.S. loan issuance in 2008 fell by 55% from 2007 – to $764 Billion, the lowest since 1994. (Source: Yahoo! Finance/Reuters Limited)

Granted, some of this is due to tightened lending standards to consumers and businesses. Some of it is due to the conscientious decision by consumers and business to shun more debt. That always happens in recessions, but a drop of 55%? There's more to blame than lending standards. The issue is availability of cash, which the banks are hoarding.

But 2008 is NOT a repeat of 2009. There are positives. There are counters to the deleveraging process and to the ills of the banks. Some are:

1. Monetary policy and other actions from the Federal Reserve have been massive. Does anyone recall that the targeted Fed Funds rate is between 0 and 0.25%? Home refinancing is exploding; near levels not seen since 2003. Homeowners are on their way to recapitalizing.
2. Foreign central banks also slashed interest rates and indicated that they will continue to do so.
3. Energy is cheap. While we can't rely on cheap energy forever (this is not a play to energy related investing or politics; simply, we just can't rely on oil when it behaves like an internet stock of 1999), it should be expected to stay cheap in time for the upcoming summer driving season. Hey, if recent frigid conditions over the last month in most of North America couldn't move the price of natural gas higher, than investors must expect low inflation or deflation for some time to come. We'd rather see more energy demand, but nonetheless, consumers have more money to spend on other things.
4. **Prices for homes, stocks, corporate and municipal debt, and commercial real estate are already marked down after the down turn that started back in October of 2007. <u>This will be the answer to the deleveraging issue above; the single greatest contributor to economic recovery over the next few years - assets are cheap for the first time in many years.</u>**
5. Borrowing is also starting from a near historic low point. Again, U.S. loan issuance in 2008 fell by a whopping 55% to $765 Billion. A small up tick in loan issuance and the ability to get more for one's money (because asset prices are cheaper) is a major way to reduce excess inventory from the system.
6. The systemic risk to the developed world's financial system has been removed due to central government intervention. Yes, there will be a heavy price to pay for this, but a heavier price would've been paid had nothing been done.
7. Corporations are moving to cut expenses. This means that on the outgoing end of the recession, profit margins have the potential to rise substantially. By the way, that's how it always happens and that's why **you get the biggest rise in stock prices early on in new recoveries.**
8. The fiscal stimulus plan will get passed in short order. This issue is saved for last due to the potential that it may be misguided, too small, too costly, or takes too long to help in 2009. In the end, it will help. Just don't expect this one to be "THE ONE" thing to get the U.S. economy moving. Not all that much will be going directly into infrastructure projects either. A chunk of it will be applied to small tax cuts, education, state social benefits programs; important maintenance issues,

but not all into those projects expected to create lots of jobs and use a lot of building materials. It will be a confidence builder, to be sure.

Where we are now?

In two places at once; a very uncertain period of bottoming and recovering at the same time. Uncertainty is a massive and destructive force behind much of the current stock market volatility. Remember, bad news doesn't necessarily drive the market lower. There's an old Wall Street axiom that says the market climbs a wall of worry. Meaning, the stock market is driven higher by its own paranoia. But the market slides down a hill of uncertainty.

Having one foot in the bottoming mud and one in the recovery mud makes it tough to walk and it forces one to expend a great deal of energy trying to move in either direction. Hence, buyers go away and sellers rule the day.

What will push us onto terra firma in recovery land?

Let's start with TARP (Troubled Asset Relief Plan). When the idea was first floated by the Treasury, Wall Street skyrocketed higher. The name "TARP" wasn't yet invented, so I called it RTC2 (article: The Game Changer/September 19, 2008), for Resolution Trust Corporation II.

The original intent of the TARP was to mimic a tried and true bail out of another era – 1989-1991. Back then, we had the Resolution Trust Corporation which was created to bail out the banking industry – more specifically, the Savings and Loan industry. It worked by taking the toxic assets off the balance sheets of banks and placing them into the RTC. This way, banks went on as banks – lending money to consumers and business. Many banks were seized. It took a few years to work. Assets were later sold and the Government made a lot of its money back. Economic recovery took hold and turned into a long and prosperous economic expansion.

The TARP of 2008 didn't work because it was changed at the last minute into making injections of cash directly into the balance sheets of banks. The banks simply hoarded this newfound cash because they needed it to protect their own balance sheets from additional write downs – from the toxic assets (mortgage backed securities, collateralized default obligations – reference "Here's why the stock market/Sub Prime/CDS – 10/28/2008", etc.) **STILL** on their balance sheets. If they didn't have the toxic assets on their balance sheets, then the cash they're hoarding would suddenly become a costly liability, not a badly needed cushion. Since banks PAY for cash, too much of it is too expensive. On the other hand, loan origination to credit worthy borrowers is how banks MAKE money.

Unfortunately, the TARP ’08 turned out to be a grandiose experiment costing $350 Billion. There is no accounting of where all that money is or went. It is easy to conceive that TARP ’09 will get more funding, but at least we can be more confident going forward. FDIC Chairperson Sheila Bair and the Obama economic team are going back to the original intent of the TARP, which is that critical removal of toxic assets from bank balance sheets. This is crucial because without any confidence in the banking system, economic activity will continue to contract. Of all the things that Government can implement now that could work relatively quickly, this author will say this is the best necessary evil we have. Add the gains in net interest margin that banks will see due to current Fed policy, you’ll finally see the banking system recapitalize. This is how the 1989-1991 period played out. What followed was healthy banking sector - a necessary component for a healthy economy.

Risks to common things you’re hearing about:

1. In a deleveraging cycle, revenues are shrinking. Companies that can make the case for revenue growth if given investment Dollars will eventually get the cash. Companies that need more cash in order to just keep the doors open will disappear.

This means that corporate bonds and preferred shares, being widely recommended by many financial advisors, **may not yet fully reflect this environment**. Also, dividend paying stocks are no less immune to the deleveraging cycle. The performance of many dividend paying strategy investment products have performed poorly and with shrinking corporate revenues, payouts will have to be reduced appropriately.

Opportunities to consider:

1. Companies that can cut expenses while maintaining healthy revenue levels and profits should emerge as the leaders in the eventual next bull market. In addition, asset prices are cheap. **The real annoyance for investors is not so much that stock prices can go down further, but that they simply expect capital appreciation much too fast.**
2. Some companies really do have the ability to maintain their dividend payout. They are also in the category of companies mentioned just above.
3. Treasury inflation protected securities (TIPS). Inflation is never dead, it goes dormant once in awhile. For those looking for ultra safety outside of CD’s with a yield that can protect against inflation, this is a very fine way go.
4. On the flip side of TIPS, commodities should eventually make a return to investors’ favor.
5. Emerging markets: The developing world is still developing. People still aspire to eat more food, drive a car, have access to running hot water, health care, amongst other things that we in the developed world are accustomed to. Ultimately, the growth rates of emerging economies should continue to speed ahead of our own.
6. Small cap companies; the places where you can often find the new “NEW” thing.

Summary:

1. The expected recovery will be here; it'll just take longer to arrive than most investors had hoped for.
2. Excess capacity throughout the global economy will be dealt with through a combination mergers and acquisitions activity and shuddered factories. M&A activity is a tell-tale sign that the strong companies are consolidating the weaklings. If this picks up, investor confidence should be reflected in higher stock prices fairly quickly. Creative destruction is painful, but it works.
3. Industrial and manufacturing capacity utilization will rise.
4. A draw down in the inventory of unsold residential homes will catch hold. Watch for a rise in first time home buyer mortgage applications. This number is still running near 8 year lows, so we're still waiting. When it rises, investor confidence should follow fairly quickly.
5. With U.S banks hoarding over $1 Trillion of cash, we'll eventually see a rise in lending – a big rise – maybe not back to 2007 levels, but we'd be happy for anything above $1 Trillion. Again, TARP would be the catalyst.

2009 is not a replay of 2008. It is, for now, the middle ground between recession and recovery. It is too late to be a raging bear and too early to be a raging bull. It is time to look at a balanced view of economics. It is time to invest a little at a time because asset prices are cheap. It is time for investors to see what else they can add to their portfolio to bring further diversification. It is time to get back to investing for the long run.

Thanks for reading this. Please forward this to anyone you know who may find it interesting. Please reply me if you'd like to comment.

Interested in becoming a client? Call me. Let's talk about it.

(Disclosure: This is solely MY opinion. Of course, you are welcome to share your opinions with me too. If you act on any of this without speaking to me first and you lose money, don't blame me. I may be wrong. I reserve the right to change my mind about any of this whenever I want and without warning. We're NOT totally out of the woods yet! Have a great day! ☺)

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