May 2009 Market Commentary

Good news seems to be easier to find. What a welcome change. Obviously, the economy has been one of the dominant news stories for many, many months as well as the gyrations of the stock market. The spotting of numerous "green shoots" of growth in the economy has created much optimism which has been reflected in the stock market. After setting records for dismal performance in January and February this year, other records for advancement were set in March and April. As of late, we seem to be seeing more subdued movements, but the general trend has still been up in April – a welcome change. While the increases fall far short of recouping the losses of the last 18 months, at least recent volatility has been mostly up.

Optimism in the banking sector is certainly one of the main causes of optimism. Given the key role the stalled credit market has played in amplifying the economic downturn, the myriad of good news from this sector has instilled valuable confidence. First quarter earnings were uniformly encouraging. Then, after the Federal Reserve had been threatening increased bank nationalization well into April, the Fed announced on April 22nd that the "vast majority banks currently have capital levels well in excess of the amounts needed to be well capitalized." This statement not only encouraged investors growing increasingly confident that the crisis has been contained, it also lessened the threat of increased nationalization which further boosted investor confidence.

Various other companies have also reported more positive outlooks with various firms across multiple industries claiming to see an end to earnings declines. Many companies, business leaders, and economists are also claiming that the general economy is approaching a bottom. Intel's CEO said the personal computer market bottomed out in the first quarter suggesting that conditions may be improving for the hard hit tech sector. Although profit was down 55%, they were better than expected. This has been a common theme – negative earnings, but not as bad as expected.

Factory orders were also up 1.8% in February. That is the first gain in six months, and even better than the 1.5% gain forecasted by economists polled by Reuters. Durable goods orders were up 3.5% in February, and orders for non-defense capital goods (excluding airplanes) rose 7.1%. The index of purchasing managers in manufacturing also moved higher for three months even though it's still at recessionary levels.

Housing is also another key indicator that seems to be showing signs of improvement. New home sales fell by 0.6% in March, which was better than economists expected. Also, Commerce Department data showed the inventory of unsold new homes shrinking from January to March, from 12.5 months worth to 10.7 months worth. And most recently, a housing index showed that home prices dropped sharply in February, but for the first time in 25 months the decline was not a record — another sign the housing crisis could be bottoming. While the housing crisis will continue as foreclosures accelerate with the lifting of various moratoriums, the sector appears to be achieving greater stability.

Consumer confidence has also rapidly improved. The index has risen more than 12 points to 39.2, up from a revised 26.9 in March. The reading marks the highest level since November's 44.7 and far surpassed economists' expectations for 29.5. The increase in confidence showed a substantial improvement in consumers' short-term outlook, including their assessment of the 44.7 and far surpassed economists' expectations for 29.5.

The conclusion to be gained from all these different numbers and trends seems to be that we're very close to the bottom. Obviously, a growing consensus that we're reaching the bottom doesn't mean it's true, but it's certainly a positive development.

Unfortunately though, it's not that simple. With all the good news, it might be a bit tempting to declare that the worst is over, and all is safe. We're probably not there yet. GDP was sharply down in the first quarter. Recently, the Federal Reserve policy makers lowered their economic outlook sharply. GDP is now projected to flatten out in the second half of 2009 versus an earlier projection of modest growth. The result is a contraction in the global economy of 1.3% in 2009 creating the deepest post-World War II recession by far.

However, to continue the optimistic theme, we seem to be past the worst, and growth is projected at around 1.9 % next year with much better projections for second quarter and beyond. In a show of gathering strength and confidence, the release of first quarter GDP contractions sparked a rally in the stock market and earlier lowered global GDP growth revisions had little immediate effect on the stock market. This is a marked change from seemingly common reactions during the last year in which negative news has caused immediate panic and lasting sell-offs.

The swine flu could also throw a kink in a recovery. While current strains outside Mexico appear to relatively mild, the world has grown so skittish that this could also prove problematic. For now, it appears unlikely to have a significant economic impact, but it's too early to draw concrete conclusions.

Regardless, long-term investment prospects appear quite positive according to numerous studies and statistics. When valuations are low, returns for the next decade tend to be quite high. By these measures, the next decades could be great. The ten-year period ended March 6, 2009 qualifies as the worst on record, with annualized losses of 4.4%. If mean reversion still applies, we could see a strong upcoming decade. There are many, many other analysis that show similarly optimistic perspectives – whether based on valuations, past returns, profitability expectations, etc. Even after the recent strong gains, the market is still quite inexpensive when looking past the immediate and likely very short term corporate depressed earnings.

This is very encouraging for those in the market or looking to take the plunge. If you're on the sidelines trying to time an entry, I like a quote from money manager Jim Stack. He's said, "Calling the turn in the market is like trying to catch a falling pitchfork. It can be painful if you miss." Unfortunately, few people time the market correctly and those who do, generally got lucky – once.

Around here we avoid playing with pitchforks regardless of the market's direction. We believe the best way to profit from the anticipated recovery is simply to participate in it whenever it occurs. This requires being in the market. As I said last month, we believe valuations are very attractive and likely represent a once in a lifetime buying opportunity. In spite of the multiple challenges facing the US and global economies, we believe now is a great time to be holding or buying assets.

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