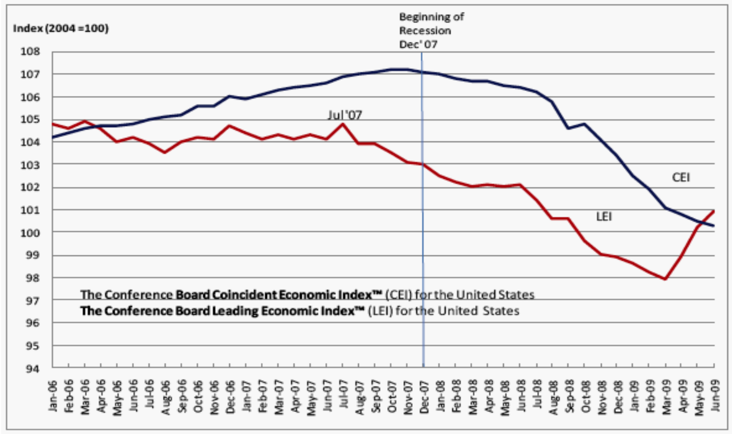
# AUGUST 2009: MARKET COMMENTARY

**Recently, the U.S. stock market has been up**, and confidence is growing that the rally will continue. While there are many reasons for recent enthusiasm, the primary drivers appear to be relatively straightforward. We'll start with the Leading Economic Index (LEI) which continues to show data that is better than expected. On July 20th, The Conference Board announced an increase in the LEI of the United States for the third consecutive month. The June gain of 0.7% follows a 1.3% rise in May and a 1% increase in April.




The red line on the chart – which shows the Leading Economic Index – shows graphically how significant the recent uptick has been.

**There are many other encouraging factors.** Ken Goldstein, economist at The Conference Board further noted that "The recession has been losing steam since the spring, although very large job losses continue…Nevertheless, confidence is slowly rebuilding. Financial markets are less volatile. Even the housing market is stabilizing. If these trends continue, expect a slow recovery this autumn."

Even before the release of these figures, other economists and research institutions were reporting much more positive perspectives. Merrill Lynch's Global Private Client Research Investment Committee (RIC) Report was titled "The Recession is Over". They reported that their global economists believe the global recession ended in second quarter of 2009, and that a fragile recovery began in the third quarter. Furthermore, they are revising growth forecasts up virtually across the globe, but most notably in the US and China. Their 2010 global GDP forecast is now 3.7%, with GDP growth in the emerging markets at 5.5% forecast to outperform growth in developed markets at 2.2%.

In addition to recent good news, part of the recent market upswing results from the contrast with current indicator levels versus historical norms. Simply reverting back to the mean of nearly any common economic measure would result in a significant increase. For example, real earnings of companies in the S&P500 dropped to a record low, and if current estimates hold, the third quarter of 2009 will see the first 12-month period during which S&P 500 earnings are negative (disproportionately influenced by the massive losses at AIG). Poor earnings drove stocks down, but the common sense recognition that earnings are expected to revert back toward mean levels from record lows is driving stocks back up.

**The combination of all these factors** is motivating predictions from various research firms projecting significant upward movement in U.S. stocks in 2009.

**However, expect to see continued major bumps along the way.** The recent near failure of CIT Group shows we're not out of the woods. More firms will fail. However, the circumstances surrounding CIT's recent rescue are encouraging. Not only did the firm survive through the help of its bondholders – at least for now – its rescue was independent of government intervention.

**Commercial real estate** is another major area likely to see significant on-going challenges. As a lagging indicator, commercial real estate is likely to continue to worsen through 2009 and beyond. About 4.5% of bank commercial real estate loans were 30 or more days delinquent in the second quarter, up from 3.6% in the first quarter, according to Foresight Analytics. While still not very high, the trend is undesirable. Yet, the banks and lenders appear to be learning and adjusting to the current challenges. Foreclosed loans as a percentage of nonaccruals have been declining, down to 19.7% in the first quarter from over 30% three years ago, according to the most recent statistics from Foresight.

Banks have many reasons not to foreclose. First, it's expensive. Second, banks make poor real estate managers. If they take over responsibility for a property and are forced to sell, they face the same distressed market as their borrowers with sales creating losses. They also have learned from past stupidity. After they dumped bad loans in the early 1990s, banks watched as buyers of the distressed loans, such as Goldman Sachs Group Inc's Whitehall Funds, made a fortune when the market rebounded.

In fact, today's environment is likely creating great opportunities. Non-traded REITs (direct investment real estate investment trusts) that are still raising funds appear to be benefitting tremendously from the current turmoil because they have cash, are raising more cash, and they're able to buy properties at currently distressed prices.

**Longer term, there are still major challenges** to be faced which will likely create a very slow recovery. Historically, recessions strongly linked to financial market issues are the longest and deepest, and are followed by slow recoveries.

**The Federal Reserve's eventual need** to reduce the monetary supply presents another major test. During the credit crunch, the Fed pumped in huge amounts of money into the economy to keep GDP from shrinking. Now, the Fed faces a major challenge. As the economy picks up, if it waits too long or acts too slowly to reduce monetary supply, we will see inflation pick up markedly. If they act too fast, we could dip back into recession.

Getting this right will be very difficult. While no one can know for certain which way this will go, most policy makers prefer acting too slow to acting too fast. From the government's perspective, inflation is preferable because it acts as a silent tax reducing the value of long term debt, and there's less cause for blame than would result from a second recession. These dynamics appear to make an increase in inflation likely at some time in the future. Generally, real assets (think real estate and commodities) and stocks perform best in the long term in an inflationary environment.

**Washington's general trend of government expansion and heightened regulation** could also adversely affect the economy. (Please note: the following comments only consider economic issues and not wider political or social issues.) Most policies being considered or already enacted are hostile to business and economic growth. And there are many worrying trends. These include the tremendous increase in size and influence of Washington; proposed and enacted punitive regulations; primary attention to big business at the expense of smaller business – the primary driver of innovation and job growth; defending the status quo (think GM and Chrysler's maintenance of bureaucracy and unions at the expense of the entrepreneurs/dealers); and health care proposals with large additional costs, especially small business.

**However, even here, a more positive trend is developing.** There is a growing pushback against this trend as more people outside the financial community and economists realize how damaging these proposals could be. While we obviously can't know the future, the ominous predictions of unending government expansion appear to be overly pessimistic. As with financial markets, the fear in this area is hopefully overdone, and sanity will return. And, even if it doesn't immediately, eventually we'll figure out the problem and move on. It's very likely a question of when the tide turns, not if.

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