February 2009 Market Commentary

Change: Yes, 2009 will most certainly be a year of change. Whether it's a new president, a challenging economy, or government's altered role, we will see change this year. Possibly less definitive is whether or not we like the change.

Challenges: President Barack Obama was sworn in as the 44th President of the United States of America on Tuesday, January 20th. The Dow reacted by promptly selling off 330.54 points on Tuesday and closing the week down 2.5%. It was the worst reaction by financial markets to a presidential inauguration in over 100 years. While this may be meaningless or even an indication of the size of the task facing Obama, there does appear to be considerable indications that financial markets are continuing to view Obama, or at least a Democratic Congress, quite negatively.

It's been widely predicted that Obama would have as much trouble working with the liberal leadership of Congress as he would with the GOP. That appears to be occurring immediately with Congress' determination to press pet projects and dubious initiatives rather than attempt systemic fixes or implement proven solutions. By any measure, Obama has his hands full.

The financial system continues to warrant attention. The most recent approach focuses on buying a portion of bad assets from banks and offering guarantees against future losses on some of the remaining assets. Parts of this concept have worked well during past financial crises in other countries. There's widespread belief that this approach will provide relief, but less certainty regarding how much assistance and how fast.

Obviously, there's still tremendous uncertainty in the economy and at political levels. Below, I've attempted to identify opportunities that can be acted on – especially those that appear much more likely than others.

Highly Probable Events/Circumstance: Our economy is facing very significant challenges causing many distressed sales of varying assets. Assets of nearly every type, size, characteristic, time frame, value, etc – except cash and Treasury Bills – are heavily discounted. While prices could always go lower, they're currently at very depressed levels and are likely to price much higher in the not too distant future.

This presents fabulous opportunities for buyers and poor opportunities for sellers. While there's never a guarantee, the wise action clearly appears to be buying discounted assets that are likely to increase in price significantly once the crisis passes. Minimally, if you don't have cash and have held onto assets, now is probably not the time to unload assets. If you need cash more than your assets, well, that's bad. You've got far too much competition from very big holders of assets who desperately need cash NOW.

Other Very Likely Events: We are going to see much more bad news. Credit card defaults, bankruptcies, layoffs, etc. will continue. However, expectations are so dire that most of this bad news is expected to have limited effect on the general prices of assets. However, it seems almost certain that news will be depressing for a while.

Stocks will lead the recovery. Stocks normally start up significantly about four months before the general economy. In conversations with large institutions that serve individuals and investment firms, a common theme is that they're holding very large cash balances. According to Bloomberg, at the end of 2008, there was $8.85 trillion sitting in cash in bank deposits and money market funds.

So, while the government is talking about some big numbers at $775 billion, if only 30% of the current cash balances are tempted back into investments, we would get three times the government plan. The superior effectiveness of private enterprise and its more rigorous review and accountability process would further multiple this amount versus any government funds. Although the timing of a major market recovery is obviously uncertain, recovery in 2009 is very possible and seems to be a foregone conclusion according to some. However, we're still heading the wrong direction on many fronts. Time will tell.

Likely Events - Credit Market to Thaw: The credit market freeze that dominated 2008 will likely ease. Consensus predictions are that the massive money supply the Fed made available to the system will find its way to the market. This helps valuations in several ways. Companies needing access to capital for growth will regain their ability to do so which increases cash flow and profitability. A more growth friendly lending environment as a result of the thawing credit market will lead to more promising prospects for corporate America. Investors will likely become less risk averse, which decreases their required rates of return to invest, and subsequently drives down the discount rate for asset valuation. These phenomena working together will likely lead to reignited interest in investing rather than hoarding cash.

Positive Signs? After a chaotic October and November, the US stock market was slightly positive in December, and the Chicago Board of Options Exchange Volatility index dropped nearly 30%. This may be a sign that investors are tired of living in panic and start to incorporate less emotion and more logic into their view of the future. Another positive indicator has been the relative winners and losers over the past month.

Also, past studies indicate that a key indicator of market troughs is the strong performance of value stocks relative to momentum stocks. Over the past 24 months, momentum stocks have outperformed value stocks. However, since Mid-November, selecting stocks on the basis of their intrinsic value has resulted in superior performance relative to price and earnings momentum strategies. We believe this as a positive development if the market is returning to its long-term tradition of recognizing undervalued companies. Or, more simply, sanity and reason seem to be returning along with greater expectations.

Less Likely Events: Don't count on real help from the "stimulus package". While government efforts are garnering ample press coverage which suggests a wonderful rescue, the stimulus package appears to be shaping up poorly. It's rapidly becoming a highly politicized vehicle filled with incredible waste and pet pork projects rather than a constructive fix for the economy.

More promising is the bad bank/good bank proposal mentioned above in which the government works with banks to get bad assets off their bank books. While it's not proven on this scale, the concept has worked in the past and the process appears much less politicized.

In spite of the challenges and uncertainty that exists and will continue, it is our strong belief that a recovery will arrive, and the economy will bounce back. And, it's likely not as far off as apparent circumstances might suggest.

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