

2nd Quarter 2009

“THE RECESSION IS OVER!” - NEWSWEEK

Employment and Payrolls

The declaration that the recession is over is based on unemployment not going down as quickly and the rate sliding from 9.5% to 9.4%. There is a lot of noise about this right now, but the only reason for the decline was because of the 422,000 drop in the labor force—the second fall off in a row. Without that bizarre development the jobless rate would have ticked up to 9.6%.

Other influencing data is that the auto sector added 28,200 jobs in July, which was the highest tally in 11 years. The 0.3% increase in the workweek was also skewed by the 4.1% jump in the auto sector as GM and Chrysler reopened plants. Average weekly earnings popped 0.5%, but again, this reflected the bounce in the auto sector as well as the 10.7% increase in the minimum wage to \$7.25 an hour.

Cash for Clunkers

First, the subsidy is for sure going to borrow from future sales. Second, the fact that people are induced to buy a new car means less cash flow being put to work for other items. Third, because older cars are being taken off the road, mechanics are being laid off. Fourth, one other effect will be to drive up used car prices.

No Credit

U.S. consumer credit outstandingly fell \$10 billion in June, the fifth decline in a row. Welcome to a new paradigm of savings, asset liquidation and debt repayment—the era of consumer frugality. After 20 years of living beyond their means, American consumers will be spending the next several years living below their means. Commercial bank lending in July showed a record contraction of \$64 billion, which is the equivalent of a 12% annualized decline.

The Stock Market

The S&P 500 has rebounded 49% from the March 9 lows. Imagine how abnormal a 49% rally over a five-month span is—it's unprecedented back to the 1930s. (See the charts in the Market Data.) This is the most speculative momentum-driven equity market since the early 1930s. The economy is getting better but many of the economic indicators are still in negative growth terrain. Economist David Rosenberg says the third quarter is all about autos—inventory rebuilding on the production side and cash-for-clunkers on the spending side. His view is the risk of a 4th quarter relapse, barring more government stimulus, is very high. He says, “What we have on our hands is a jobless, revenue-less, income-less, profitless and consumer-less recovery. It's one of a kind.”

The S&P 500 Index is currently selling at a 65x P/E based on trailing earnings and a 16x P/E on 2010 earnings. This is a wide range. We will probably end up somewhere in the middle.

Conclusion

The Dow is up 6.8% YTD, the S&P 500 is up 11.9% YTD, and the NASDAQ is up 26.8% YTD. The Dow is down 17% from December 2007, the S&P 500 is down 19%, and the NASDAQ is down 16%. Our clients did not go down near as much as the market in the second half of 2008 and the first two months of 2009. We have remained cautious all year with a heavy allocation to bonds generating positive returns for the year lead by such managers as PIMCO, who is up approximately 8.0% YTD through August 7.

It is very tempting to chase the market up, and we are as tempted as any other human being. The market was way oversold by the end of

February 2009 when it was worried about another depression. Today the skies have cleared some and a depression is not in the cards. The worst is over, but clouds remain on the horizon. Many very bright market gurus think that we will have a “V” shaped recovery and then the market will go nowhere for a long time. They think we are close to the top of the “V” shaped recovery. Others think we will test the lows of early March. Jeremy Grantham of GMO thinks that the market is fairly valued now. He says that the “rally had absolutely nothing to do with the logic of long-term fundamentals, but was merely a response to great stimulus and great implied promises.” He thinks the “Chinese economy is dangerously unbalanced and very likely to come unhinged in the next few quarters.” Mark Mobius at Templeton is expecting a 20%-30% correction in the global market. Bloomberg also reports today that Warren

Buffet is shifting out of equities and into U.S. corporate bonds and foreign government bonds.

We continue to be cautious and, therefore, are recommending that our clients stay at 20% equity and 80% bonds. We will be talking about one change when we meet with you to review 2nd quarter results. We will be recommending that you move out of the 5% energy investment and spread the proceeds over the rest of your 20% equity exposure. Since 2004 we have made a lot of money in commodities. In 2004 it was an easy decision to invest in commodities. Today we don't know which way it will go.

Jamison Monroe, CIMA
Chairman & CEO
Director of Corporate Values
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