



Economic and Financial Crisis Update Recovery and Rebuilding June 2009

Although the economic affects of the financial and economic crisis linger on, the financial part of the crisis has ended and the financial markets have begun their healing process. In fact, it is normal for the stock market to begin to recover before the economy, as market participants begin to anticipate an end to the global recession that began in 2007. The stock market will not wait for an “all clear” signal from the economy. Rather, the market just wants to see that the bottom of this economic cycle is near, and I believe that it is. Therefore, we have been investing slowly in relatively small portions back into equity funds in many of our clients' accounts over the last few months in anticipation of an economic recovery soon.

There are several reasons why I believe the financial part of the crisis is over. First, stock market volatility is receding from record-high levels. Typically volatility is at extreme levels at market bottoms and then recedes when bear (down) markets are over and confidence returns. In addition, credit spreads have been narrowing. Credit spreads represent the difference between risk-free U.S. Treasury bond yields and the yields on various other types of riskier bonds (corporate, mortgage, municipal, high yield, etc.). When the difference between yields on Treasury bonds and other types of bonds widens, it is a sign of risk aversion. This is because during periods of economic turmoil investors sell most types of bonds that have risk and invest only in risk-free Treasuries. This drives Treasury yields lower and the yields on other types of bonds higher. When credit spreads narrow, with Treasury yields rising and other types of bond yields falling, it is a sign that investors are willing to take on more risk and financial panic is abating.

Another positive sign is that market rallies during the last several months have generally been on higher trading volume than that found during market corrections. This higher trading volume indicates that market advances are due to large institutional buying of stock, and market pull-backs are due to normal profit-taking by traders—*not* the kind of institutional selling and redemptions that occurred from September 2008 through March 2009. In addition, market breadth (the number of stocks and the number of shares advancing versus declining) is much better lately than at any time over the last eighteen months, indicating that the market trend is now positive. It now appears that the stock market crash initially bottomed on November 20, 2008, and was followed by a re-test of that low on March 9, 2009. * As I indicated in prior updates, market bottoms typically make a “W” formation with an initial low and then a short-term rally followed by a re-test of the low or a slightly lower low. This technical market pattern recently occurred, indicating that the worst of this bear market should be over. Finally, while the stock market has had huge declines and massive, short-lived snap-back rallies over the last eight months it has recently stabilized into a trading range. This type of relatively stable consolidation is healthy for the stock market. It indicates that the market has found equilibrium after the crisis, with almost equal numbers of buyers and sellers willing to buy and sell stock at current market prices. In other words, the market appears to have settled on the correct current valuation for stocks.

Extraordinary government fiscal and monetary stimulus is starting to stabilize the economy, and economic growth should return by the third or fourth quarter of this year. Although, this growth may not be as significant as prior economic recoveries and it may take many months or years for the economy to fully recover from the worst economic crisis since the Great Depression. In addition, this new bull market in stocks may only be short-term in nature as opposed to longer-term secular bull markets that have occurred in the past. However, just the fact that we are now seeing signs of recovery (as opposed to the unprecedented economic catastrophe we experienced over the past year) is encouraging.

The reason the stock market may be entering only a short-term bull market is that the steps that the government took to stabilize the banking system, stimulate the economy, and bring the financial markets back to life may have unintended consequences in the future. For example, the unprecedented amount of spending that the federal government has approved requires the government to borrow a huge amount of money by issuing an enormous number of Treasury bonds. At some point, interest rates could rise significantly if purchasers of Treasuries demand a higher rate of interest from the United States to compensate for increasing credit risk. In addition, the amount of money that is being created by the Federal Reserve Board to stimulate the economy could lead to a weaker U.S. dollar and result in significant inflation in the future. The Fed may need to increase short-term interest rates to try to prevent inflation once the economy begins to recover, which may lead to below-average economic growth or even a stagnant economy.

The velocity and sustainability of the future recovery will depend largely on the ability of policy makers to, when the appropriate time comes, withdraw the stimulus without hindering the recovery or allowing inflation to damage the economy. A sign that the Fed is not withdrawing liquidity out of the economy fast enough and that the extreme debt is becoming a problem for the U.S. economy would be a weakening U.S. dollar and rapidly rising interest rates. If that happens, commodity prices will rise and commodities (like gold and silver), emerging market stocks, and inflation-protected Treasury bonds would most likely benefit at the expense of most other U.S. stocks and bonds. However, if the Fed is successful in winding down its stimulus programs from the financial system and the economy can begin to grow enough to provide necessary tax revenue for the federal government to pay off debt, the stock and bond markets could continue to recover over the long term.

Regardless of how successful the government is in exiting the stimulus programs, at least we can now consider a recovery and are no longer watching an economy and stock market continuing to spiral downward. While the long-term effects of the recent financial meltdown and the ensuing policy responses are still uncertain, it now appears that at least there *will* be a recovery. All of us can be relieved that the concerns regarding whether the economy and the markets could recover following the collapse of many major large financial institutions and whether there would be another great depression have now given way to how strong the recovery will be and when jobs will be created once again.

Everyone has been affected differently by the recent crisis, but all of us have been affected in some way. We appreciate all of our clients' continued support and patience, and we will work hard to help our clients rebuild their portfolios and financial security for the future. This crisis has been compared to a once-in-a-hundred-years flood. While floods cause damage, the waters always recede and then people rebuild. That is what we intend to help our clients do using a variety of investment strategies over time.

As always, please call me if you would like to discuss your portfolio or the financial markets further.

** Information was obtained from Ned Davis Research in May, 2009.*