

## Investment Update First Quarter, 2009

The end of the first quarter marked the 15<sup>th</sup> month of this U.S. recession, and it has been almost 18 months since most stock markets began to slide in earnest. Both the economic recession and the bear market have lasted a good deal longer than usual.

This recession has been different from all others in recent memory and much worse than we anticipated, and so to a large degree we are in unfamiliar, uncharted territory. The bad news, though it is hardly news anymore, is that the global economy is very weak, and after having shrunk by 6.3% in real terms during the fourth quarter of last year, the U.S. economy will probably have declined by a similar amount in the first quarter of 2009. Headlines are still dominated by the negatives, including rising unemployment, shaky banks, growing local and national budget deficits, and dramatically reduced global trade flows. Nevertheless, the sequence of events that we first laid out last October which would lead to an eventual economic recovery is unfolding roughly as we expected, and an upturn before year-end still seems possible.

One reason for optimism is that in the background, behind the changing array of ad hoc bank bailout programs and toxic asset recovery plans and all the attendant political heat and noise, some of the ongoing Federal Reserve and Treasury interventions seem to be working.

The Fed has aggressively eased monetary policy, first through its traditional rate-cutting mechanism (the federal funds rate was lowered from 5.25% in September 2007 to a targeted rate of 0% in December 2008), and more recently it has begun an unprecedented direct expansion of the money supply via Treasury bond purchases. As a result interest rates have come down all along the yield curve but especially at the short end. Mortgage rates have dropped from roughly 6.5% last October to around 4.5% now. Lower mortgage rates combined with lower home prices have greatly increased the affordability of housing in many areas, and potential buyers are starting to respond.

Many of the Treasury's interventions have been controversial, generating a great deal of criticism as inconsistencies and frequent changes both to the focus of the interventions and to the rules of the game have made investors extremely hesitant to commit capital in the face of so much uncertainty. But the underlying policy of doing whatever is necessary to prevent the abrupt failure of any more systemically important institutions has been a key reason that credit markets have begun to thaw.

Some positive signs from the credit markets are that credit spreads have narrowed, the yield curve is now upward-sloping, and the markets for new corporate debt and convertible issues have reopened. An upward-sloping yield curve, with short-term rates lower than long-term rates, gives banks more opportunities to earn their way out of some of the troubles of the past few years.

Beyond the credit markets, some other economic indicators at least have stopped deteriorating and may in fact be stabilizing:

- *Consumer spending has improved, and retail sales, excluding automobile sales, increased 1.7% in January and 0.7% in February compared to the previous month.*
- *Auto sales and residential housing activity have reached such low levels that they are unlikely to decline much further. For example, cars and light trucks have been selling at an annual rate of about 9 million units, not nearly enough to replace the 12-13 million vehicles that are scrapped each year.*
- *While home prices are still falling in many areas, affordability is greatly improved and more buyers seem to be shopping for homes.*
- *Many commodity prices that collapsed in the second half of 2008 have begun to recover, particularly oil and copper, which are the most economically sensitive.*
- *The Baltic Dry Freight Index of bulk shipping rates has risen about 150% from its December low.*
- *China's economy has slowed, but continues to grow.*

Another positive development is that the Obama administration's budget for massive deficit spending on non-emergency projects seems to be running into bipartisan resistance. Also, the same budget that proposes so much spending does contain some good news. The budget proposes to eliminate capital gains taxes for small businesses. This proposal can be seen as a tacit acknowledgment that taxes on capital do affect business formation and investment, and that if the goal is to grow the economy with the help of small business, tax cuts help.

There is also considerable and growing support for a more common-sense application of the mark-to-market accounting requirements for financial institutions, particularly banks and particularly when it comes to measuring their regulatory capital levels. A more flexible approach would recognize that market prices for assets do not always indicate their true value. For example, if a bank holds a mortgage that is current, where the homeowner has sources of income that will permit them to continue to make payments as agreed, should the bank have to write down the value of that mortgage (and therefore impair its capital) simply because, at the moment, there are few bidders for that sort of asset and the market price at which the mortgage could be sold is much less than the face value of the loan?

So at the end of the first quarter, we can say that the economic news is mixed, and that is a marked improvement from its having been consistently negative.

Stock markets here and around the world have taken notice of these slight improvements. We have said all along that these markets will tend to anticipate economic recovery well before it is clearly under way, and if recovery is to begin later this year, then the equity markets have responded right on cue. Although the major market indexes are still well down for the year, the strong rallies since the first week of the month have turned March into one of the best months ever.

For the quarter the Financial sector was the worst-performing, but did have the strongest rally at the end of March. If the rally in Financials holds, that, together with the accumulating signs of economic stabilization, will likely be seen as a sign that the worst is over. A crisis in the Financial sector triggered the global recession and the bear market in stocks, and a sustained recovery is unlikely until the Financial sector stabilizes and begins to heal.

By many measures, stocks as a group are quite cheap, particularly if estimates for company earnings this year and next have been slashed enough, and in general we are more inclined to buy stocks than sell them. Given how far stock prices have fallen, returns from this point forward will probably be above average for some time. However, while we are glad to see signs of life, we still think that any recovery will take place in fits and starts. To the extent that we do have cash to invest in stocks, we will put it to work incrementally, as we usually do.

Our outlook for interest rates is that they will eventually trend higher. Treasury yields are especially likely to move higher from today's extremely low levels, although the Fed's direct purchases of Treasury debt are temporarily delaying any upward movement. Higher inflation at some point also seems very likely. Given those expectations, we think that Treasuries are still relatively expensive; we prefer shorter to longer maturities, and investments that offer some form of inflation protection still seem like a very good idea.

<b>Markets</b>	<b>Calendar 2008</b>	<b>1st Qtr 2009</b>	<b>3/9/09 - 3/31/09</b>
<b>Dow Jones Industrial</b>	<b>-33.8%</b>	<b>-13.3%</b>	<b>16.2%</b>
<b>S&amp;P 500</b>	<b>-38.5%</b>	<b>-11.7%</b>	<b>17.9%</b>
<b>NASDAQ Composite</b>	<b>-40.5%</b>	<b>-3.1%</b>	<b>20.5%</b>
<b>MSCI EAFE</b>	<b>-45.1%</b>	<b>-14.6%</b>	<b>15.9%</b>
<b>MSCI Emerging Mkts</b>	<b>-54.4%</b>	<b>0.3%</b>	<b>17.4%</b>
<b><u>Sectors</u></b>			
<b>Energy</b>	<b>-35.9%</b>	<b>-12.1%</b>	<b>+9.3%</b>
<b>Materials</b>	<b>-47.0%</b>	<b>-2.8%</b>	<b>+22.4%</b>
<b>Industrials</b>	<b>-41.5%</b>	<b>-21.8%</b>	<b>+22.0%</b>
<b>Consumer Discretion</b>	<b>-34.7%</b>	<b>-8.6%</b>	<b>+23.1%</b>
<b>Consumer Staples</b>	<b>-17.7%</b>	<b>-11.3%</b>	<b>+9.5%</b>
<b>Financials</b>	<b>-56.9%</b>	<b>-29.5%</b>	<b>+42.1%</b>
<b>Health Care</b>	<b>-24.5%</b>	<b>-8.5%</b>	<b>+11.8%</b>
<b>Technology</b>	<b>-43.7%</b>	<b>+3.9%</b>	<b>+20.7%</b>
<b>Telecommunications</b>	<b>-33.6%</b>	<b>-8.5%</b>	<b>+16.0%</b>
<b>Utilities</b>	<b>-31.5%</b>	<b>-11.9%</b>	<b>+14.6%</b>