CONWAY • JARVIS

Quarterly Investment Outlook

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Trader's Rally or a New Bull Market?

We're going to live!! That's the message the market has been sending the last 90 days as it has advanced some 40% off the March 9th lows to where it now hovers, near the prior lows of November 21st. We had called for a reaction rally of only 25-30% in Q1 and have been pleasantly surprised at seeing our modest expectations exceeded. However, we still view this as a trade-driven rally rather than a sustainable one that will bring long-term investors back to the market. That distinction is lost on the touts at CNBC who can't wait to get another party started. Their mantra has been and still is "Buy now, party on, and it will all work out somehow". However, the really big money is in the hands of investors who want to own rather than rent stocks and they are withholding their RSVPs to this party. They remain on the sideline, not buying into the idea that a slower rate of erosion in consumption and employment is the new "up" in today's economy. They would take the other side of the argument that this rally marks the beginning of a new Bull market. While we're delighted to celebrate the survival of the Financial System, we still see a long period of de-leveraging before us and think today's Bulls will be disappointed with the long, slow-growth recovery that we believe lies ahead. Many of the characteristics of a new Bull market are in place, what's lacking are the necessary expectations for growth that will sustain higher valuations from here.

No Quick Fix for the Market

We see a number of reasons for the market to correct in the coming months: An anemic "E" (earnings figure) for the S&P 500 that puts forward-looking valuations in the 18-20 P/E range, hardly a bargain in the aftermath of the worst recession we are likely to see in our lifetimes; More trouble developing for Bailout Nation as the world's 8th largest economy (California) sinks nearer to fiscal meltdown; Commercial real estate delivering another blow to the balance sheets of banks and insurers; And finally, lower employment, and consumption continuing to leap-frog one another on the downside well into 2010. Any of these will do nicely as a catalyst for the market to retrench, especially when combined with the current declining volume and narrowing breadth in the market that has stalled the indexes below important resistance levels.

This is not a prediction of disaster for stocks, but rather a reminder that putting a bottom into this Bear market will take time and that it's likely that we'll see a U-shaped bottom to this economy and a W-shaped bottom to the market. As much as we'd like, we don't see any classic "V" bottoms for either headed our way. That alphabet soup is consistent with our view that this rally will fade in the coming months as valuations more accurately reflect the paucity of growth we predict for the US economy over the next few years. That's not to say we will revisit the March 9th lows, but only that a 15-20% correction from current levels wouldn't come as a surprise and would be a welcome opportunity to position certain issues at prices lower than we see today.

Lights in the Tunnel

Lest we appear as doomsayers, there are some very good reasons why stocks have advanced over the last several months. Just as we have seen the Great Recession of our lifetime, so too have we seen the greatest amount of economic stimulus. TARP, TALF, PPIP, Quantitative Easing, and the Great Bailout of the autos were enacted to resuscitate the US economy. It took the US almost a year to deploy $2 trillion in programs and projects. The same thing in China was accomplished with $600 billion and a phone call. While the US package lumbered through Congress and was laden with pork and programs of the future, China spent its money on "stuff" that will be built today and maintained to employ people now rather than years later. That would explain the resurgence of demand for commodities and materials that has ignited a recovery in the Asian markets and signaled to the world that China will navigate through this recession with positive GDP growth and may lead the way out of the downturn. That's an important light at the end of the tunnel and noteworthy in the wake of this significant rally.

Light #2 is the US financial system. Its viability is no longer in doubt and offers the promise of stable capital markets to fuel a recovery here at home. The only downside we see possible is a hyperbolic response by Congress that could flat-line US growth through over-regulation or a subversion of the markets by the administration through its attempt to save everyone. This week, the Treasury rebuffed appeals from California and the auto parts makers for financial aid. While encouraging, we still worry that political expediency and the inability of past and current administrations to say "NO" could doom us to repeat Japan's experience of the past twenty years, a development that would not be well received by the markets. However for now, the stock market has successfully traversed from fear of a systemic failure to mere disappointment over the character of the recovery that lies ahead. That's a big step in the right direction that has increased our appetite for risk and led us to position issues that we believe have seen their worst price levels for years to come. In accordance with that view, we no longer see the need for conservative investors to hedge portfolios and recommend using the correction to close out short positions.

Looking in the Rear View Mirror

It's time to revisit our "Wish List" of actions by the Fed and Treasury that we felt had to be in place to stabilize the financial system before looking ahead to any possible recovery of the economy and its markets. Most of them have been enacted. TARP and TALF combined to stabilize the banks and begin the restoration of credit flows. FASB adapted the mark-to-market rules to current market conditions, another step toward increased credit. A return to the pre-2007 short-sale rules is under consideration and likely to occur before the end of the summer. The few remaining are currently being addressed: It appears the FDIC will fill the role of the Resolution Trust-type entity that we called for to preserve healthy banks and euthanize others. We have full confidence in Sheila Bair's integrity and abilities but have concerns that the process will be politicized by the agency's dependence on Congress for additional funding that will almost certainly be needed if we see hundreds of banks "put down" this year. Last on our list was the very subjective matter of seeing Meredith Whitney and Noriel Roubini turn bullish on the banking system and the economy. They're not there yet but we'll still call it good because even they see a functioning financial system in our future, albeit a smaller and more regulated one.

Over the last few quarters, you've heard us say that we would forego committing new capital to equities until we saw the bottom of the market in our rear view mirror. Looking back to the lows of March 9th, with the indexes off some 60% from their November '07 highs, investors were questioning whether the financial system, as we know it, would even survive as nationalization of the banks and auto companies loomed. A lot has happened since. Obviously, there's no guarantee that the market won't make new lows but we've seen enough happen in the last few months to increase our appetite for risk and pursue opportunities in issues that we believe have put in their respective bottoms.

Recent Actions

While waiting for the correction to materialize, we've methodically increased our exposure in areas that don't strongly correlate to the stock market: In Fixed Income, we've abandoned low-yielding cash for short-term corporate bonds and preferreds as conditions in the credit markets have improved appreciably. We've owned the Gold ETF for some time and recently positioned a short ETF in the 20-year treasury, anticipating a re-inflating of the economy as a result of global stimulus; We are currently buying the Natural Gas ETF, anticipating a rebound in price and a narrowing of its discount to the price of oil. With equity money, we've positioned a few "deep value" issues that have increased their dividends recently or offer yields comparable to those of investment-grade bonds. Our plan is to increase exposure to market-correlating issues as prices retrench. Sectors where we plan to increase exposure are: Energy (all types); Tech/ Telecom; Commodities/Materials; Foreign (Emerging Asia, China, India); and selected Transports.

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