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Quarterly Investment Outlook

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Mixed Signals From Stock and Bond Markets

A year ago, as Lehman Brothers teetered on the brink of failure, the Fed and Treasury feverishly peeled away the layers of the financial system in search of the problem. What they found at its core were the decaying balance sheets of the world's largest banks and brokers. We suspect they couldn't believe what they were seeing. We now know what they saw, how it happened, and whom to blame (The list is too long!). The economy now looks like it's about to take its first steps on the road to recovery, back to being an economy where markets determine winners and losers. Until then, government is picking the teams, paying the players, and changing the rules of the game as needed to make sure there are no losers among those deemed "too big or to important to fail". The necessity of this can be debated but all agree this should be a strategy of limited duration. Japan played this game for years and, in trying to save everyone, severely impaired its economy and markets. We hope Washington is paying attention. Avoiding a repeat of Japan's experience will require discipline on the part of our fiscal and monetary policy makers. Granted, that's a quality rarely associated with government, but the stock market is optimistic and telling us the recession is over and a robust recovery is just around the corner. At the same time, the bond market is telling us that, in a post-stimulus economy, the recovery road may be a long, winding, and bumpier one than many think. Which one do you believe?

A Year to Remember

Next week marks the one-year anniversary of the failure of Lehman Brothers, one of a string of shocking events that would stretch from Wall Street to Main Street and beyond to the far reaches of the Global Financial System. In the wake of the biggest bankruptcy in history credit markets around the world seized up and equities markets crashed. With hindsight, few will disagree that what followed was the worst threat to our financial system since the Great Depression. It appears that we will survive what is now being called the "Great Recession" but there is much uncertainty as to how the global economy will look afterward and what type of recovery lies ahead.

The equity and bond markets are forward-looking and good indicators of investors' view of the future. The rally in stocks that followed the last of the market meltdowns in March is reason for optimism. As we see it, that advance celebrates the survival of the financial system and its markets and anticipates an imminent end to the recession. There are plenty of reasons to agree with the stock market's view of things: the declines in housing and employment are slowing; leading economic indicators are hinting of improved demand; some industrial indexes have turned positive; Q2 earnings, while contracting, exceeded analysts' estimates and appear to be leveling off; and there is increasing evidence that credit flows are improving. All of these are good news and indications that the government's stimulus efforts are bearing fruit. We agree and believe we could be seeing an end to this recession by year-end or, worst case, early next year.

Good Market, Bad Market?

One would think that the end of a recession would mark the beginning of a recovery and it usually does. However, when looking at what might follow this Great Recession, we can't help but think that this recovery will be challenged in ways not usually seen following your typical run of the mill recession. So far, the market's bull run of the past 6 months has defined the March 9th lows as a "V" bottom for stocks though it's now being viewed as a bit long in the tooth by some analysts who are calling for a modest correction. Aside from that, tech and quant-driven market pundits remain staunchly bullish and many who favor fundamentals point to a trend change in unemployment and a return of the US consumer in 2010 as cause for the return of the Bull Market. As an investor who incorporates all three disciplines into our process, we can see how they might arrive at that conclusion. In fact, we would add that the tons of cash on the sidelines coupled with meager returns from bonds and real estate make stocks look even more enticing. So why are we nervous?

Because the bond market is singing a different tune and because we think the bond market is "smarter" than the stock market. In the aftermath of arguably the worst downturn of our lifetime, the stock market is telling us that a robust recovery is in the offing and investors' appetite for risk has returned in a big way. The bond market is saying "Not so fast". With treasury prices at all time highs and yields at all time lows, we think the bond market is singing in harmony with the Fed about the threat of deflation trumping that of inflation for the next year or so. That means full recovery could be much further away than stocks are indicating.

While the recession may be nearing its end, we think analysts (and the stock market) are underestimating the length of time and deflationary effects of de-leveraging the economy. We believe the banks and FDIC have been slow to mark down loan portfolios. This could make it tougher for the Fed and Treasury to successfully perform its balancing act. If the Fed leaves rates too low for too long and the Treasury fails to reel in the stimulus it has deployed in a timely manner, a decimated dollar could send inflation spiraling out of control. If they act too soon, the economy could lose traction and tip over into a second, less severe, "double-dip" recession that would delay full recovery for at least a couple of years. Until we get a clearer picture of which outcome will prevail, the cash on the sidelines and in bonds is likely to stay there a while longer with the market left range-bound. We should get our first clue as to which way the economy tips when the Fed's treasury purchase program ends in October. The disappearance of quantitative easing and the bond market's reaction to it should give us a hint as to the strength and direction of a recovery in the post-stimulus era.

Perspective for Investors

This uncertainty shouldn't dissuade investors from entering the market but should determine how, when, and where they invest. Remember, it's not a matter of *if* but *when* and *how* the economy will rebound. In our view, a slow, low-growth recovery is still a recovery to which the markets will react accordingly. Today, we see conditions not seen since those of 1973-'82, that until now was the worst period for housing, inflation, and consumption since the '20's. And while the Bears and short sellers point to the fact that the lows of 1982 were *below* the highs of 1973, it was a time to be *selectively* invested in both stocks and bonds. ***Selectively.*** That means using a rifle-shot approach to concentrate capital within a few sectors and in specific companies, countries, and asset classes that will reflect the unique character of this recovery. This will require that investors employ a more tactical approach to committing capital and be willing to follow the strength that will rotate through the markets as the recovery unfolds.

They used to call this a stock-pickers market. But today, with the proliferation of derivative products, the term now includes foreign securities, commodity, and directional index ETFs that don't necessarily correlate to the US stock market. There are more ways and opportunities to invest than ever before. **There is something for everyone but it's critical to their success that investors look in the mirror and ask: Who am I? And what am I trying to accomplish?** Investors with high-risk tolerance who seek performance should be pursuing global growth opportunities in Info Tech, Financials, Commodities, Consumer Discretionary, and weak dollar/inflation derivatives. Investors who see themselves as defensive and risk-averse should also position a value-based mix of global Staples, Utilities, Healthcare and other dividend-paying issues, coupled with a combination of short-term bonds and preferred shares (which will have to be sold at the first hint of inflation). The key for both types of investors is to focus on companies that benefit from growth in the Emerging markets and, in most cases, avoid those that limit their business to the developed economies (US and Europe).

Keep in mind, this recovery is unlikely to resemble those of the past twenty years. There is still a good amount of structural repair underway in the credit and capital markets. Commercial real estate is tumbling even as the residential market shows signs of stabilizing. This spells trouble for most financial institutions and constrained credit should be with us for some time. The volatility of the Emerging markets, which is a significant source of business for US-based companies, will make this recovery non-linear and unpredictable. Investors should be prepared for the broad market indexes to reflect uncertainty over how well the Fed moves us through recovery while keeping inflation in check. This will be reflected in the markets and we are likely to be buffeted by the occasional "correction". However bumpy the ride may be in the markets, we see trend change firmly embedded in the economy and that's reason enough to invest.

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