

INVESTMENT QUARTERLY

DRIVE FOR SHOW, PUTT FOR DOUGH

With the return of Spring and Tiger Woods to the PGA Tour, the old golf saying, “Drive for show, putt for dough” has become a metaphor for economic and market conditions. While congress, the administration and the Federal Reserve have been booming drives off the tee with expensive alphabet solutions to the financial crisis, Tiger has shown that it is how you putt that wins the match. Every week there seems to be a new program announced by the government designed to restore confidence and sanity to the credit markets. The only good thing you can say about most of these programs is that they are pumping money into the economy, even if much of it does not land in the financial fairway. To win the match, however, we need to finish the hole by putting out and this is where the government programs have yet to succeed. Putting requires confidence, an ability to read the slope of the green, and experience to know just how to direct the putt and how fast to hit the ball. In a sense, we are all beginners playing on a challenging economic golf course without the skill to putt for dough. And, there are no pros around to teach us the finer points because this is a new game for all of us.

What do we expect of the economy in the coming months? For starters, we have held the belief that the 4th quarter of 2008 and the first quarter of 2009 are likely to be the worst from an economic reporting standpoint. There certainly is no benefit to showing good earnings in this environment so it is likely that earnings will reflect write-offs of all but the most guaranteed profit generating assets. The catalyst for the disappointing economic outlook is the serious decline in revenue that is facing both large and small businesses. In a sense it is the logical conclusion to a period of serious deleveraging in the world as significantly declining sales are the direct result of less spendable money in the hands of consumers. Some economic forecasts are projecting that consumer spending will fall back to the historical average of 65% of Gross Domestic Product versus the 71 to 72% it has been running in the recent leverage charged years. Sixty-five percent of a GDP that is down 10 to 12% represents a huge drop in consumer spending. The offsets could come from capital expenditures but with autos and manufacturers of capital goods facing declining demand at home and abroad it doesn't look like this sector will provide much impetus. The last sector to boost the economy is the government, but here as well, most of the money spent has disappeared into the “black hole” of boosting the liquidity of our financial institutions. Larger businesses are still having trouble borrowing so capital expenditures and inventory will only increase after demand builds up and funds become available. So far the booming, high profile money drives from the government have landed primarily in the rough.

Other economic indicators such as corporate profits, unemployment statistics, housing foreclosures, and the auto industry are all heading in disappointing directions even though we are getting some comments from the administration and the fed that there are signs of a slow down in the rate of economic decline. At the same time there are mounting concerns that credit card debt and other asset backed bonds may start to come under pressure which could be considered piling-on to the already weakened financial sector. It is incredible to realize that nobody in government seemed to understand that capital injections into the financial industry would just be used to shore up their teetering financial position rather than making funds available for lending to keep the economy going. Of course the congressmen who provided the money the banks are not lending,

because they were prohibited from expanding their loan portfolios as regulators said they didn't have enough capital, are now verbally shredding the banks. And we thought the Keystone Kops went out with the silent movies!

Where do we see the markets at this point? We have long felt that stock market success was based on the three-legged stool philosophy where one leg is liquidity, one leg is inflation or interest rates, and the third is corporate profits. At this time liquidity is strong as measured by the growth in the money supply (M2). The Fed has been growing this component by over 12% for the past three months, an extremely aggressive posture. Interest rates and inflation are at historic lows, an extremely positive indicator. The last leg, corporate earnings, however, is the big question mark. Since this is a world wide economic crunch we are more dependent on how the world recovers than just our own economy. Earnings projections for the S&P 500 are retrenching to the \$50 level, down from their peak of \$87.72 in 2006 and \$65.39 in 2008. Until earnings show signs of leveling off this out of favor leg should keep pressure on the market, leading to continued volatility until the earnings outlook becomes more favorable.

Our clients know that we have followed an equity discipline that favors low price to cash flow ratios and high returns on total capital. By all of our metrics there are some outstanding values in this market environment if, and it is a big if, corporate earnings stabilize and begin to move up. Nobody can have great confidence in their forecasts at this time because we are on a new course, designed to lead you to the sand traps or water when you least expect it. The hazards are so well hidden that you don't even know they are there until you can't find your ball on the fairway. Shots that look like winners when they start out manage to end up in impossible lies. These are still difficult and dangerous times even though the press rhetoric has shifted to "good news". What we need is a financial Tiger Woods who can confidently stride to the green, get a good read of the playing surface, and then calmly, and deliberately stroke the ball with the right trajectory to sink the putt and pick up the winners check. We haven't seen any evidence yet that there is a financial Tiger out there but we have seen a lot of congressional and administration John Daley's hitting booming drives off the tee that don't end up with a good lie for the next shot.

With Treasury bond yields unexciting it makes sense to stay short in fixed income investments. Expectations are that bond yields will rise in the future either from inflation caused by the huge monetary injections into the economy or due to lack of foreign interest in our bonds because of a weakened currency, the result of our lack of monetary constraint. As interest rates rise, bond prices decline, so anything but short-term bonds carries a rather large risk it appears to us. On the other hand, if it takes the S&P 500 average 10 years to get back to its former high of 1469.25 as some of the more pessimistic forecasters have predicted, that still represents a 5.4% compounding rate for the market. If you add a 3% dividend to that, equities could offer an 8.4% annualized return over the next 10 years, a much better return than bonds at this time. As in the past, however, if the market does reach that average return it won't be a straight line and may actually show some near term weakness before the problems get fully sorted out.

For the first quarter the S&P 500 lost 10.93% and the DJIA lost 12.43%. The Lehman Intermediate Government Index, after a stellar 2008, showed a decline of 0.08%, almost a flat performance.

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S&P 500	797.87
DJIA 30	7608.92
LIG	1475.13

(as of 3/31/2009)