Investment Commentary
April 2009

Our field is overrun with complicated charts, but here's an exception:

	3/09/99	3/09/09
S&P 500 index	1280	677

This ten year period, representing a 47% price drop from start to finish, a -6.5% annual clip, is made better by dividends, but not much…about 1.7% a year, reducing the annual loss to 4.8%. The worst ten year move I was able to find during the Great Depression was a 60% drop (the S&P index falling from 32 to 13), which translates to an 8.5% annual decline. But during this period the dividend yield averaged 5.5%, thus trimming the annual loss to 3%. This means the recent ten year span has seen the worst total return *ever* for stocks, including the 1930s, and any other ten year period you could pick over the last 180 or so years.

If there is good news here, it's what history tells us typically happens after our worst ten year periods. According to the Leuthold Group (courtesy of Byron Wien, Pequot's CIO) if you take the top 15 worst decade spans since the 1929 crash, again none worse than the entry above, the average cumulative total return over the next ten years was 183%, nearly a triple: $10,000 becomes $28,300. The range is 101% at the low and 325% at the high, or, to keep it in baseball terms to fit the season, from no worse than a double to something better than a home run.

Of course, it's still the future we're talking about. And one could argue that the world has greatly changed, and our country's standing within it far different than was the case through most of the last century. This is a time that has introduced us to a crisis of unprecedented origin – an overleveraging that brought down our largest financial institutions – followed by a monetary and fiscal response of unprecedented scope. All we really know is that we're in transition and the scale of it is likely major. Uncertainty is the great market underminer, and we have that in spades right now.

However, the flip side of uncertainty is opportunity. Things could turn out very well for talented investors. As we suffer through a time of painful, rapid job loss and unemployment rates approaching double digits, we remember that the only year other than the 1930s in which unemployment exceeded 10% was 1982. This was during Ronald Reagan's first term, another time of dramatic regime change following a troubled presidency. The best bull market in history unfolded over the next 17 years. Along similar lines, it is possible that this time may be viewed someday as one of the great inflection points.

But at the moment we're still trying to navigate our way out of the woods, not sure whether flashes of daylight are real or flares in our hopeful imagination. The performance of financial markets in the first quarter seemed to trace progressing views of whether the pace of economic deceleration was easing, perhaps signaling a bottoming out and then, at some point, recovery. January and February were dominated by the grim returns from the fourth quarter of last year, during which our GDP declined by 6.3% and corporate earnings posted a severe aggregate loss after write-downs. We also saw unrelenting job losses, and uncertainty about the new leaders in Washington. By March 9th, the date in our opening table, U.S. stocks were working on a 2009 loss of 25%, and the EAFE non-U.S. index was down 29%.

The final three weeks of the quarter saw a quick turnaround, triggered by signs of economic improvement. Stocks made back more than half of their 2009 losses, the S&P and EAFE indices finishing the quarter down 11.0% and 13.9%, respectively. The employment picture has continued to be very bleak – following the March report, 5.1 million jobs have been lost since the beginning of 2008, including 2 million this year. But several other indicators have offered evidence that the economic downslide is slowing – including housing, still the core concern. Recent reports indicate restoration of new and existing home sales growth, and even a glimmer of relief in pricing. And while signs of relief in the job market have yet to appear, employment reports generally are deemed a lagging indicator, more reflective of corporate headcount attitudes a few months back.

Bond market performance also has indicated some easing of investor fear. U.S. Treasuries were 2008's big winner, rising 13.7% while most other categories suffered losses, including Treasury Inflation Protected Securities/TIPS (2.4%), municipals (2.5%), emerging market bonds (14.7%) and high yield bonds (26.2%). In the first quarter of this year, however, Treasuries as a group were down 1.3%, while gains of 4-6% were posted by the other categories. Corporate bonds were a notable exception; they were down 1.9% as a group over the recent three month period on the heels of a 4.9% loss last year. But outside of financials, gains were achieved in most corporate bond sectors over the quarter.

While we sort out whether or not economic and corporate fundamentals are improving with any staying power, at a time when many indicators are still faint, there is nothing subtle about the transition that is taking place under our new president. Barack Obama has put forward a government agenda that is dramatically more activist than we saw under George Bush or any other recent predecessor. Obama has taken advantage of a crisis atmosphere, fully tapping into a perceived electoral desire for major change. Yale political science professor Stephen Skowronek calls this phenomenon the "authority to repudiate", which enables massive course changes following presidencies deemed unsuccessful. Other examples would include Lincoln after Buchanan, Roosevelt after Hoover, and Reagan after Carter.

Obama's proposed budget for the fiscal year ending 9/30/10 speaks volumes. It is at the same time impressive in the scale of its vision and frightening in the scale of its numbers.

The initial release in February called for total spending of $3.6 trillion, a number that would be double the $1.8 trillion the government expects to take in, implying a $1.8 trillion deficit. The government's size would represent roughly 25% of our total GDP, and the deficit would be in the 12% neighborhood, the latter figure shattering the post World War II record of 6% during Reagan's first term. Obama is breaking away not only from the Reagan years of major non-defense spending cuts, but also the Clinton years of fiscal thrift; in fiscal 2000, we were in a surplus position, spending $1.8 trillion on receipts of $2.0 trillion.

Obama is tapping his authority to repudiate in a very front end-loaded manner, no doubt recognizing that the authority will only diminish from here. He and his economic team express through both the budget and the $787 billion stimulus program that near term economic prods must be paired with initiatives that enhance competiveness and efficiency down the road. This assertion supports the president's major investments in his "big three" focus areas: health care, energy and education. No doubt, our current plight, and constant parallels drawn with the Depression and 1990s economic fall of Japan, lend legitimacy to this approach, and also present Obama with a chance to put virtually his entire campaign platform in place all at once. If done successfully, he could consider the implementation of his capital projects complete, redirecting his energies toward day to day operating issues over the rest of his tenure.

Of course, this is an "if" of epic proportions. First, the White House must navigate the budget shaping and approval process on Capitol Hill. It is possible that nods to political expediency could in fact make the deficit outlook worse – such as removal of the "cap and trade" program, a revenue generator and clean energy incentive that would raise energy costs for consumers during what are very tough times. And longer term, much depends on the strength, and more critically, sustainability, of what economic recovery comes our way. A sluggish performance, combined with any return of higher interest rates, would lead to a much more entrenched sequence of large annual budget deficits and accompanying steady increase in national debt.

More immediately, lasting and substantial recovery cannot begin to happen until the financial system, and banks in particular, regain significant strength. The importance that the financial markets rightly attach to this, combined with their current starvation for real information in times more characterized by mystery, was underscored by a 379 point March 10th gain in the Dow, due almost entirely to the revelation of an internal memo from Citibank CEO Vikram Pandit noting profits at the bank in the first two months of the year. Hopes surrounding the Treasury's public/private troubled asset transfer program, aimed at freeing up bank lending, have had dramatic market impacts in both directions: a 382 point February 10th loss when secretary Tim Geithner, in a much anticipated appearance, did not offer details of the plan, and a 497 point gain on March 23rd, the day he did.

As we've said in previous letters, during any recovery process mystery has to give way to knowledge, troubling though it may be. Whether the Geithner partnership program succeeds in substantially clearing bank books is very important, and we will know a lot more over the next few months. And if the program does indeed start moving, what the pricing of these transactions looks like also will be critical, and we may see signs within several weeks. It will be a delicate balance: bargain prices are what the private entity/taxpayer tandem should be looking for, but if the prices are too low we face a new round of worries about the solvency and operating viability of the banks, raising the nationalization prospect that no one wants to face. This will be a telling spring.

This brings us to that key transition point, at which uncertainty and opportunity coexist. Our task is to construct portfolios for both, as best we can. As noted in the last letter, we began the year with added commitments to a variety of bond categories where we saw (and continue to see) value, including TIPS, municipals, and corporate debt. We also feel absolute return managers should be able to perform well as volatility persists, but with continuing normalization of trading conditions compared to 2008. And we maintain exposure to commodities, as a diversifier and play on eventual economic recovery here and abroad.

As for the equity markets, we gain exposure through a combination of long-only and long/short managers. We believe today's environment lends itself particularly well to active management; the divide between winners and losers should become more striking, and well chosen companies that defend or increase market share, generate cash and maintain dividend payouts should begin to stand out as investments after a year in which everything was sold indiscriminately. While much attention is fixed today on where S&P 500 earnings as a whole are going – and no doubt, this is important – there is much opportunity for skilled managers and analysts to find strong earners at the grass roots, individual company level.

It surely is too soon to proclaim an end to the crisis, as there are too many variables yet to be solved. We still have the weight of leverage to deal with, as new austerity drives at the banking and individual levels are giving way to historic borrowing at the federal level. But even as this sorts out, the investment talent that has survived this crisis will have money-making opportunities, perhaps major ones. As investors, there are many things to be worried, but at the same time excited, about as we seek greater energy efficiency, a smarter banking system, and better cars. After the worst ten years ever for U.S. stocks, perhaps factoring in the prospect of a second depression, some actual data, housing included, suggest possible improvement.

We hope the early spring is treating all of you well. Please call or e-mail anyone on the investment team with any questions or concerns. Your continuing trust in our firm means everything.

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