Economic and Market Commentary
08.17.09

This month, I would like to begin our newsletter by again addressing one of the questions that started last month's letter:

Is the economic recession over?
I do believe the recession is over – for now. Unemployment seems to be stabilizing (the rate of job losses is slowing). GDP numbers came in better than expected last week. Even new home construction shows signs of a modest rebound. However, the largest element contributing to the perceived economic stability is the government's economic stimulus efforts. We have never had government intervention like we are currently experiencing. It is absolutely unprecedented and makes me very nervous. We do not know the long term effects of these historic efforts but it appears that in the short term they have been successful in halting the recession.

I have remained skeptical of the stock market's consequent rise. At the March lows, valuations were much higher than previous stock market bottoms. At true secular bear market bottoms, the public is absolutely sick of stocks and P/E multiples contract to 5 or 6, instead of the 10 multiple we had in March. That said, we have experienced an incredibly powerful rally, and I have been frustrated by it. I have maintained a very defensive stance, carrying high cash balances to protect against a violent downturn. Not since the Great Depression have we seen a rally like this one. (Incidentally, that rally faded to new lows within a year.) Currently, the market has priced in a strong economic recovery. This growth cannot be derived from corporate and economic data that are primarily "less bad." At some point, we must actually have good results. *(P/E statistics taken from www.standardandpoors.com)*

While I am surprised at the strength of this rally, we do not have to swing at every pitch the market gives us. The worst thing to do is to allow ourselves to be driven by frustration and emotion – which are always the enemies of prudent investing. Patience is of utmost importance during this time.

Will the markets continue to go up?
Approximately 15% of the government's announced stimulus plans have actually been spent to-date according to CNNMoney.com. It is possible for these on-going stimulus efforts to create the short term appearance of a continued economic rebound. Consequently, it seems possible to me that the market's current rally may extend higher. Much like a fire that quickly burns up lighter fluid ---- sooner or later you have to burn real wood to get sustainable heat.

Do you recommend investing more aggressively in this market?

It is reasonable to move cautiously back into this market -- however not with the typical economic recovery investment profile. We must choose wisely where and when to participate. Active management over the next market cycle will make an enormous difference in returns. The following is a list of concerns that prevent me from advising strong participation in this rally, in spite of my recognition that it could continue:

1) Real estate is still fragile: Residential real estate mortgage defaults are still rising. Significant volumes of troubled loans are scheduled to come off of teaser rates in the next 21 months. Commercial real estate is also experiencing rising default rates and declining values. Larger defaults than are currently expected by the market could derail the economy and the market's rebound. *(Mortgage reset data taken from Dr. John Hussman economic commentary.)*
2) Credit is still contracting: Banks are bracing for significant write downs from the real estate market and have consequently tightened underwriting standards on new loans. Thirteen of the fifteen largest banks in the country have experienced shrinking loan portfolios every month since last summer. Economic expansion is not possible without a significant reversal of this trend. *(Bank statistics taken from July 27, 2009 article in the Wall Street Journal.)*
3) The end of the recession does not necessarily mean the beginning of economic expansion: Current expectations are that the stimulus plans will be the genesis for future economic growth. However, we won't know whether this works until the stimulus money is fully spent. Recoveries from similar past recessions here in the U.S. have taken far longer than the current expected recovery time. If the stimulus plans fail to generate lasting economic expansion, the markets will be significantly exposed.
4) Stocks are expensive: Over the last 70+ years, stocks have traded at roughly 15 times trailing earnings. Currently, stocks are trading at around 19 times expected earnings for 2009. Basically, the risk of failure is very high. The economy not only has to stabilize ----- it must grow substantially to justify the market's expansion. *(Statistics taken from www.standardandpoors.com.)*

The Bottom line:

In light of the stabilizing economy, we are looking for opportunities to cautiously deploy capital. Significant longer term risks to strong economic expansion and the markets are still very real. Our priority will continue to be managing risk. We continue to believe that the best sources for strong investment returns will come from alternative spaces. Thus, we continue to have significant exposures to high quality market neutral hedge funds and will be rolling out several opportunities in the next 90 days with compelling risk-adjusted return profiles.

I trust that your summer is winding down well. Personally, I am certainly looking forward to cooler weather, football season, and the arrival of our baby girl in just over two months! As always, it is a privilege to steward your capital and work with and for your families.

Warm Regards,

Jeremy Boynton
Principal