

Prepared Comments from 4/15/2009 Conference Call

My last conference call was on March 16th. US stocks had risen 11% in the prior week, and since that call have risen another 13%. Does this mean that there is light at the end of the tunnel?

The Markets

The broad S&P 500 index peaked at 1,565 in October 2007. It had fallen 52% by last November 20th, and then recovered a little by year-end. But the next ten weeks brought a new low March 9th, at 677, down 57% from the 2007 peak. To fully recover we need a 133% gain (almost 900 points on the S&P). Well, in the past five weeks we have managed a 26% gain, of 175 points, as currently it's at 852.

During the past calendar quarter, bonds generally rose under 2%. Strong results were posted by high yield bonds, inflation bonds, emerging markets bonds, and municipal bonds.

During the quarter US stocks fell about 11%, foreign stocks fell about 14%, while emerging markets rose about 1%. Stocks had a tough January and February, but began to recover in March. Mid cap stocks fared better than both large and small caps, and growth stock funds, led by a 4% gain in technology stocks, outperformed value stock funds -5% versus -12%. Real Estate stock funds, after falling almost 38% in 2008, fell 32% in the quarter.

The Economy

The US economy continues to shrink, and with that, unemployment is rising and loan delinquencies are increasing (leading to growing foreclosures). Unemployment is currently at 8%, and appears to have several more months of climbing. Mortgage delinquencies are a bit over 6%, and consumer loans (credit cards, car loans, etc) have delinquencies of about 4%. Corporate loans delinquencies are under 3%.

Personal savings rates have climbed to 4.3% of disposable income, a level last seen a decade ago. Housing prices continue to fall, although coupled with fallen mortgage rates, housing affordability (at 13% of average household personal income) is at the best level in over 30 years. While corporate profits have fallen sharply (from their peak of over 9%), currently at about 7%, they remain comfortably above the 50-year average of 6% of GDP.

'Headline' Inflation, which averaged 4% in the past 50 years, is currently under 2%, and is near zero when you include energy and food. World oil consumption fell in 2008, the first time in over 20 years. This led to the incredible rout in oil prices in 2008. The modest 2009 increase in oil prices indicates that oil traders believe that the global economy is nearing a bottom, and that demand will begin to rise fairly soon.

Fed chair Ben Bernanke gave a talk on the economy yesterday. He addressed four major questions/themes. How did we get here, what is the Fed doing to address the situation, does the fed's aggressive response risk inflation down the road, and why did the Fed and the Treasury act to prevent the bankruptcy of some major financial firms (and not others)? These four questions framed his prepared comments, and I give him high marks for knowing what are our top concerns, and for sharing his answers and thoughts on these four topics. I continue to believe that as the economy recovers he and the Fed will take appropriate measures to back out the steps they have taken in the past six months, steps which if not backed out as the economy recovers, would almost certainly lead to sharply rising inflation.

The other high area of inflation concern (but which is outside of the Fed's area of responsibility) is the fiscal stimulus from the White House and Congress, and the inflationary implications of large budget deficits. Here, too, it is important to have a clear path for backing out stimulus spending as the economy recovers. This is the reason that such stimulus should be (should have been) designed to be significant, fast-acting, and temporary. Temporary stimulus of this nature will not perceptibly affect inflation.

Economic theory and practice calls for the federal government to run deficits in recessions, and to run surpluses during healthy times. Today's current and imminent federal budget deficits do not yet concern me. I do, however, want to see the budget deficits fall sharply as the economy recovers. We are in somewhat uncharted waters, and no one can properly estimate when the economy will be back on its feet, companies will return to normal profitability, and individuals will be on firmer financial footing, all of which will lead to stronger federal government income. As such, I am willing to give Congress and the White House more time to demonstrate financial discipline.

Stocks are Cheap

The S&P 500 has a current dividend yield of 3.6%, which is more than its 47 year average, and more than double its 10-year average.

The 2000-2002 bear market was led down by the technology sector. Clearly this bear market is led by down by the financial sector, with able assistance from the housing sector. While the 2008 S&P's operating earnings are down 40% from 2007 levels, much of this is due to the financial sector's meltdown. When you carve out financials and housing, the operating results are not that bad. The manager of the Intrepid Small Cap fund said that the difference between this decline and the 2000-02 bear market "is that, then, lower-quality companies got killed. This time, everything declined." Even with the recent rallies, "we're still finding value. We've got a long way until we get close to what these businesses are worth."

I examined Procter & Gamble during last month's call, not to suggest that you purchase its stock, but as a proxy for the US stock market. It trades 35% below its 2008 peak price, and yet its 2010 earnings per share are expected to be 33% greater than its 2007 earnings. It pays a 3.4% dividend, and is expected to grow its earnings at a 10% annual pace for several years. I consider P&G to continue to be attractively priced, and, by extension, that the US stock market continues to look attractive.

The financial troubles were global, but were worse in some areas than in others. Certainly the US led in many areas, including in steps to fix the problems and to help its economy recover. Remember, however, that foreign economic growth rates have remained higher than US rates for more than ten years. The stock market losses overseas has been greater than here in the US, providing further reasons to build foreign stock positions in your portfolio.

Bond are more interesting now than they've been for years, but many popular types yield too little to justify adding to them. Ten year Treasury inflation bonds yield only 1.4%, while 10-year Treasury bonds yield 2.7%. 10-year municipal bonds yield only 3.5%. Today's interesting bonds include US high yield bonds. Their current yield may fully cover the default risk, currently about 6%. Default rates peaked in the early 1990s at the 15% level, and yet then yields only just reached the 10% level. Today's 15% level appears quite tempting! The strong results of the US dollar versus other currencies may make foreign bond investing worth considering.

Gameplan

I continue to recommend that investors utilize a Firewall approach to their portfolios, separating the safer holdings (cash and bonds) from their riskier holdings (stocks of all flavors), and placing a mental Firewall between the two sections. While stocks appear cheap, you should try to restrict your withdrawals to only come from behind the Firewall (cash/bonds). This enables you to avoid selling any stocks during downturns. As we see stock values more fully recover, then you can replenish your depleted, Firewalled assets, by selling shares of stocks/stock funds at recovered levels.

Opportunities

Investors are humans, and they (we) overreact. Treasury bonds appear very over-priced. Stocks appear underpriced, as do high-yield bonds. Real estate stock funds have been beaten down so far that I am comfortable building a 2% or so level within most portfolios. I expect to build that towards 5% in the next year or two. While I expect the US economy to recover sooner than continental Europe's, given the large level of losses in overseas stock markets, I am comfortable maintaining a 'neutral' weight on foreign stocks, which I typically set at 1/3rd of the total amount in stocks. Thus if you currently have 40% of your portfolio behind the firewall, with 60% in stocks, you can consider directing 20% of your portfolio into foreign stocks, with 40% in US stocks.

Emotions and Investing

Are we there yet, have we reached the bottom? Perhaps. My guess, and that is all that it is, is that we reached the low point of the stock market last month, and that the US economy will post small gains before the end of the year. I expect that we will get a bit more bump in stock prices as the bipolar investors who jumped to cash in November and February to avoid the losses which they had already suffered, will partially jump back into stocks (after having missed the most recent 20+% gain). I expect a very bumpy path forward, with continued large moves up and down. That said, the Firewall approach insulates your withdrawals from this bumpiness, and from the need to figure out 'when it is safe.'

I do think that there is light at the end of the tunnel, however that light has been flickering all during this turmoil.