

### March 2009: End of Bear Market in Sight?

The severe bear market environment has continued into the first sixty days of 2009. With the S&P500 down nearly 21% for the calendar year at the time of this writing, investors have experienced the worst 2-month start of a year in the history of the S&P.

Obviously, the economic numbers have been grim as a result of consumers cutting back significantly on purchases and increasing their savings – which is understandable given the current environment of fear and the relentless decline in asset prices.

At the moment, we seem to be trapped in a vicious circle where declining asset prices cause more risk aversion, in turn causing economic activity to slow, which causes more investors to liquidate long-term investments. However, cash is being stock-piled (around \$10 trillion at the last time we checked) and the government is expanding the monetary base dramatically and holding the overnight fund rates near zero. At some point the downward spiral will be broken and this cash will likely be deployed into riskier assets. What breaks it and when is the big question.

The catalyst of this market downturn was the rapid deterioration of the balance sheets of banks and other financial institutions like AIG and GE. As we've spoken and written about many times, today's problems tie back to the credit markets' dysfunction after many years of excess, poor oversight, lax regulation and misaligned reward systems in the nation's largest financial institutions. The process of correcting and rebalancing those factors has been very painful for many investors.

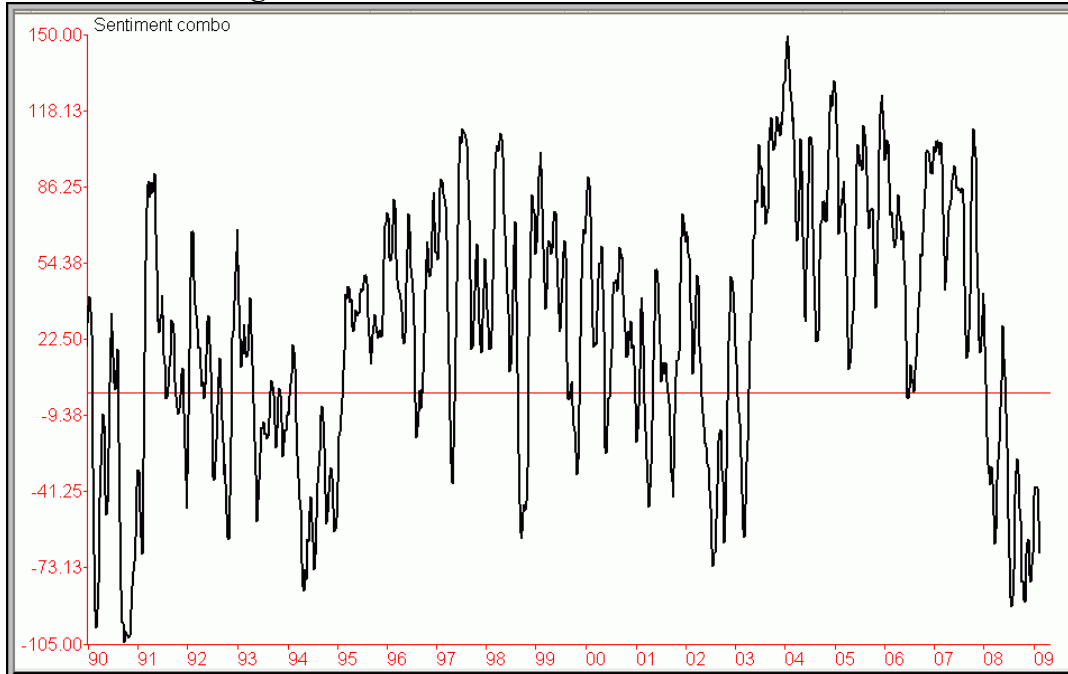
It is debatable whether the government interventions to date have been helpful. Roughly two-thirds of the credit that was provided to the economy before the collapse came from capital markets or from institutional investors (e.g., hedge funds, pensions, endowments). When the government changed the rules of investing and intervened to prop up the stocks of poorly managed banks last summer, it signaled to investors that the government wasn't afraid to manipulate securities prices to support its agenda. These actions caused many investors to experience significant losses on sensible trades, thereby drying up the credit previously provided by these same market participants.

The U.S. taxpayer stepped in to inject capital into many institutions through TARP and other bailout programs in order to prevent a systemic collapse. For example, the government has committed \$150 billion so far for AIG (a company with virtually no equity value at the holding company level) in order to save its counterparties from failing. Furthermore, swelling government commitments, promises of reduced deficits, and plans to increase taxes on investors has not been received well by the market place.

While this backdrop is dismal, much negative news is already priced into the market. The poor economic outlook and drastic declines in asset prices have generated extremely low

sentiment readings -- which are often associated with important market bottoms. As such, we may be close to the end of the worst part of the declines in stocks, although sentiment is not a perfect market timing tool.

### Sentiment Readings: 1990 to Present



Source: Larry Katz, [www.marketsummaryandforecast.com](http://www.marketsummaryandforecast.com)

The recent rally in gold, which may be due for some near-term profit taking, signals that the reflation effort is gaining some traction as the stimulus plan and the Capital Assistance Program (CAP) for banks have been adopted. The CAP plan is a necessary step to break the financial crisis as it essentially subjects 19 of the major banks to stress tests and provides them with equity capital based on estimates of their potential future writedowns. In exchange, the taxpayer receives a convertible preferred share that pays a 9% dividend and is convertible to common either at the bank's request or at the end of seven years.

Despite the large cost to the government, the strategy outlined in the CAP may stabilize the banking system, **which is a necessary condition to eventually stabilize the economy**. Investors may argue about the details of the bailout plan, but the Administration has committed to a reasonably clear bailout strategy and has served notice that it will not allow any of the 19 systemically important institutions to fail. The CAP will serve as a platform for further bank support if financial woes continue to escalate. We believe the plan will go a long way toward breaking the above-mentioned vicious circle that is undermining the economy. However, the stress tests won't be completed until the end of April, making the interim investment environment challenging and uncertain.

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