

Market Review & Outlook

April 2009

As the month of March came to a close, investors seemed to be regaining an appetite for risk after a quarter that was very tough overall as the major market averages all fell below the levels of late November to make new lows. However, over the last several weeks of the quarter, stocks stopped their free fall and staged a dramatic turnaround, with the S&P 500, Dow Jones Industrial Average, and NASDAQ Composite all



surging 20%+ off of the low points reached on March 9. Technically speaking, if one goes by the somewhat subjective definition of a bull market being a 20%+ rise in the market, then we are currently in a new bull market. While we certainly view this development as positive, it's important to remember that this is the third such 20%+ rise in the market since the October crash, and while there have been some signs that economic conditions are improving at the margin (or at least not getting worse), there is still a lot of bad news out there, and most professional forecasters believe that global economic activity will decline for 2009 as a whole. For a detailed look at how the stock and bond markets performed last quarter, please refer to the table below:

Even so, it's interesting to note that while the market was roaring ahead over the last half of March, economic forecasts for the full year were being downgraded by various prominent organizations. Just in the past month, the Organization for Economic Cooperation & Development (OECD) predicted that 2009 global output will decline by 4%, the World Bank forecast a drop of between 1-2%, while the International Monetary Fund (IMF) estimated that the decline will be much milder in the 0.5-1% range.

While these numbers don't necessarily shock you in the context of say, the US GDP declining at a 6.3% annual rate in the 4th quarter, the fact is they are very unusual as world economic output as a whole has not declined in any calendar year since World War II.

Over the last year and especially in the past six months, the Department of Treasury and the Federal Reserve have taken extraordinary measures to alleviate the severity of the financial crisis and keep the economy from sliding into depression. According to a story on Bloomberg News on March 31, the total amount spent, lent, or committed by the U.S. Government and the Federal Reserve now totals an astonishing \$12.8 trillion, or an amount approaching the entire GDP of the country last year. Jim Bianco of Bianco Research did some number crunching, and to put this bailout tab in context, it exceeds

Index	March 2009	1st Qtr. Performance	YTD Performance	Description (what the index is comprised of)
S&P 500	8.50%	-11.70%	-11.70%	Large cap stocks
DJ Industrial Average	7.70%	-13.30%	-13.30%	Large cap stocks
NASDAQ Composite	10.90%	-3.10%	-3.10%	Large & mid cap tech stocks
Russell 1000 Growth	8.90%	-4.10%	-4.10%	Large cap growth stocks
Russell 1000 Value	8.60%	-16.80%	-16.80%	Large cap value stocks
Russell 2000 Growth	9.00%	-9.70%	-9.70%	Small cap growth stocks
Russell 2000 Value	8.90%	-19.60%	-19.60%	Small cap value stocks
MSCI EAFE	6.40%	-13.90%	-13.90%	International stocks
Barclays Cap Agg Bond Ind	1.40%	0.10%	0.10%	U.S. Government bonds
Lehman High Yield	3.20%	6.00%	6.00%	High yield corporate bonds
3-month Treasury Bill	0.00%	0.10%	0.10%	

As you can see from the table, March was a strong month across the board for the various asset classes and one of the best months for the market in a number of years. The stock market is said to be one of, if not the, best forward looking indicator for the economy, and during past economic downturns the market has begun to rebound an average of roughly 6 months ahead of the real economy hitting a trough.

the combined inflation-adjusted cost estimates for the following big budget government outlays over our history: the Louisiana Purchase (\$217 billion), the New Deal (\$500 billion), U.S. cost of World War II (\$3.6 trillion), the Marshall Plan (\$115.3 billion), the Korean War (\$454 billion), the race to put man on the moon (\$237 billion), the Vietnam War (\$698 billion), NASA budget since the moonshots (\$851.2 billion), the Savings & Loan crisis (\$256 billion), and the invasion of Iraq (\$597 billion). Wow! In retrospect, it looks like all of those things, at a total cost of \$7.52 trillion, were a relative bargain compared to what we are going through right now!

Well, it might be funny if it didn't have such negative implications for the future and also be so controversial, as many parts of the bailout packages have been. Many of the actions taken in response to the financial crisis have some wondering if the cure might be worse than the disease. Fed chief Ben Bernanke is an expert on the Great Depression, a topic about which he has written extensively during the course of his career. His belief (and the belief of a number of prominent economists, including the late Milton Friedman) is that the Great Depression would have been much less severe had the Fed not allowed the money supply to contract by approximately a third from 1929 to 1933. In other words, what might have simply been a severe recession set off by the financial shock of the 1929 market crash turned into the episode that is etched in history as the benchmark for economic misery in modern times. The Japanese experience also points to the need for rapid monetary stimulus in response to market meltdowns. The country has never fully recovered from its own stock market and real estate crashes of the early 1990's, and many fault the Bank of Japan for its slow response to slash rates and avert a deflationary spiral.

Consequently, Bernanke has been determined not to allow the same thing to happen this time around, lowering short term rates to zero, setting up special lending facilities for the troubled banking sector, and growing the money supply at an unprecedented rate. According to several sources, the money supply has grown nearly 300% in the past 6 months whereas the previous highest annual rate of increase since 1960 was 16% in 1985. Because this money supply growth is so unprecedented compared to anything we've ever experienced, it's difficult to say what the repercussions will be, but the Fed is clearly worried about deflation and has used just about every policy tool at its disposal to avoid it. So far, it seems to be working. However, many knowledgeable pundits say the Fed is risking runaway inflation and severe dollar depreciation should they miscalculate in their implementation and wait too late to reverse this extremely accommodative monetary policy. Indeed, many lay the blame for the housing bubble at the feet of Greenspan and the Fed as they kept interest rates so low for so long in the wake of 9/11 and the technology bust.

This is why anybody paying attention to the financial press over the past 6 months has seen these perma-bear, end-of-the-world types crawling out of the woodwork advising folks to load up on gold, which has intrinsic value compared to a fiat currency like the dollar. Except now, these people don't seem quite as crazy as they used to. It's also why you have Chinese Premier Wen Jiabao saying a few weeks ago that China is "definitely a little worried" about the value of the U.S. bonds Beijing has purchased with the dollars piled up from her trade surpluses with the United States. If the dollar depreciates substantially, the value of foreign dollar-denominated investments would decline dramatically when translated back into their home currencies.

A scenario like this could cause a flight of foreign capital out of US markets, but with the dollar still firmly entrenched as the world's reserve currency and US treasury securities still considered "risk-free," the probability of this seems fairly low.

When will the economy show improvement and is this rebound in the market the start of something meaningful? Even relatively optimistic economists believe the economy is unlikely to show any improvement until the end of the year, and forecasts of no upturn until mid-2010 are common. Although the unemployment rate is a lagging indicator, initial jobless claims are a leading indicator, and until their ascent slows and flattens out, there's little hope that things are set to improve in the near term. As for the stock market, while the recent action is encouraging, there's really no reason to think this is anything

other than a nice bear market rally and attempting to fundamentally value stocks is very difficult due to low earnings visibility.

That said, for retirement plan investors with long term investment horizons, it doesn't really make a lot of sense to get out of stocks and go to money market or stable value funds as the market makes new lows if you have ridden it all the way down, and that's true even if the lows of early March fail to hold. Conversely, if you are somebody that got out of

the market back around Dow 9,000 or so, you've realized no benefit if you wait until the market goes back up to 9,000 to get back in. The fact that money funds are yielding returns near zero makes this even more so. Year to date, the asset classes that are performing the best are largely the ones that did the worst last year. In the U.S., the average large cap growth fund has a near 4% return as of April 2. Overseas, emerging market stocks have far outpaced shares in developed countries. The best performing sector is technology and in the bond market, high yield bonds are outperforming quality corporates and government bonds.

If you have a general question about your account, please contact our customer service at extension 152. If you need investment advice, please contact me or your firm's designated consultant. You can reach me at 800-535-4253 ext. 178 (510-740-4178) or at john.w@wespac.net. John Williams, Manager of Advisory Services – WESPAC

