

Market Review & Outlook

July 2009

Considering the global economy and markets have over the past year experienced the worst financial shock since the Great Depression, stocks have shown remarkable resilience during the past several months as they posted their best quarterly performance in 10 years. Stocks rallied strongly throughout the last half of March and April, and though the momentum of the rally slowed in May, the markets continued to grind higher until mid-June, rising more than 40% off the lows of March 9th. Many professional investors and strategists have been skeptical of the rally. They believed the economy to still be in very bad shape and that the initial move off the bottom was propelled by short covering. That's where an investor who had sold stock in hopes of re-purchasing at a later and lower price, changes their mind and buys it all back in a hurry to narrow the amount of losses incurred. While the initial burst off the lows may have been driven by short covering, one could also say that all new bull markets start off this way. Another worry was that the move has been straight up and that there has not been a substantive pull-back during the rally. Indeed, this rally was unprecedented in the number of trading days that it went on without any meaningful dips. Finally over the past 3 weeks markets have begun to show some weakness, including a 90% downside volume day (90% of the volume on the exchanges was in declining stocks) in each of the 3 weeks, something that normally portends a down trending market. For a more detailed look at how the stock and bond markets performed last quarter, please refer to the table below:

Index	June 2009	2nd Qtr. Performance	YTD Performance	Description (what the index is comprised of)
S&P 500	0.00%	15.20%	1.80%	Large cap stocks
DJ Industrial Average	-0.60%	11.00%	-3.80%	Large cap stocks
NASDAQ Composite	3.40%	20.00%	16.40%	Large & mid cap tech stocks
Russell 1000 Growth	1.10%	16.30%	11.50%	Large cap growth stocks
Russell 1000 Value	-0.70%	16.70%	-2.90%	Large cap value stocks
Russell 2000 Growth	3.20%	23.40%	11.40%	Small cap growth stocks
Russell 2000 Value	-0.30%	18.00%	-5.20%	Small cap value stocks
MSCI EAFE	-0.50%	25.80%	8.40%	International stocks
Lehman Aggregate Bond Index	0.60%	2.20%	1.90%	U.S. Government bonds
Lehman High Yield	2.90%	23.10%	30.40%	High yield corporate bonds
3-month Treasury Bill	0.00%	0.00%	0.20%	

Will we revisit the lows of early March? Obviously nobody knows. Our position is that we are in a bear market until proven otherwise and we position ourselves with continued caution. As so often happens with the overall psychology in the markets, the mood changed rapidly over the course of a few weeks back in March and April. In early March, many pundits were still talking depression and saying that the Dow Jones Industrial Average was going to 5000. Then, as the short covering rally took hold and the market started to move off the bottom, the release of economic data began to suggest that conditions, while not

necessarily improving, were no longer worsening. This optimism began to spread as the number of jobs lost began to decline from month to month and consumer confidence began to improve. Not only that, but by all accounts, most institutional investors were still underinvested in the market and had a lot of cash in their portfolios. As the markets continued to move higher, these institutional investors were pressured to put this cash to work so as not to fall too far behind their benchmarks. This created further upward momentum in the rally.

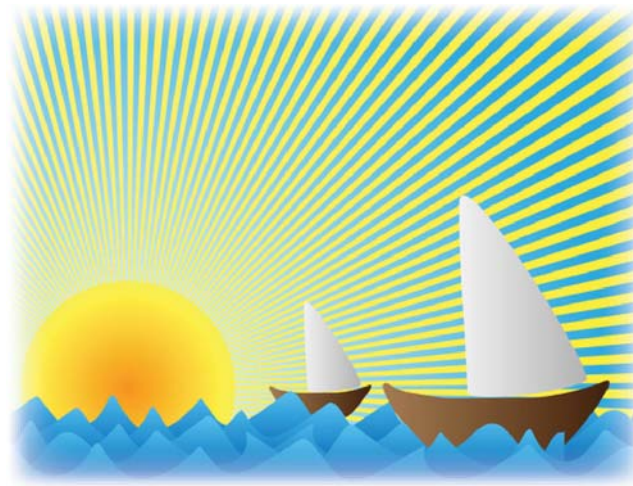


However, over the past weeks, this optimism has begun to dissipate. Trading volume has been declining, showing a lack of conviction, and market leadership has been narrowing, meaning that fewer and fewer stocks have been continuing to surge ahead. In addition, recent economic data has not continued the positive trend that seemed to be taking hold a couple of months ago. Non-farm payrolls fell by 467,000 in June, much higher than analysts' estimates of 350,000 and the May figure of 322,000. This is discouraging because of

the potential effect it has on consumer behavior. While economists love to point out that unemployment is a lagging indicator and will typically not peak until well after a recession is over and the recovery in progress, from the public's standpoint, all they see is that the unemployment numbers continue to go up and this creates a lot of concern for the safety of their own jobs. And with the unemployment rate at

a 26 year high of 9.5% and rising, this headline has the power to continue to keep consumer spending down as consumers save more and change their spending habits. Consumer spending contributes roughly 70% to domestic economic growth and any declines at the margin can have serious consequences, and since July of last year, personal consumption expenditures are down every month except for January and February, and those months may have seen declines too had it not been for government stimulus efforts.

Speaking of government stimulus efforts, aside from the aforementioned short term boost to consumer spending, it is unclear what positive effects the stimulus package has had thus far. Reportedly, only about 10% of the funds have actually been released, calling into question the claims of so-called "shovel ready" projects that were often mentioned leading up to the bill's passage. Historically, strong free market economists have criticized fiscal stimulus plans because the timing and implementation of such plans often negate their impact or in some cases actually do harm. There are several reasons to support this rationale – Important provisions may be bogged down in political considerations during passage, funds may not be dispersed in a timely and efficient manner because of bureaucratic rigmarole, and the implementation of the stimulus may hit the economy at a time when it is no longer needed or appropriate and cause unnecessary inflationary pressures. Finally, it is questionable whether or not people really change their behavior in response to policy changes that they know to be temporary. Recent studies of tax rebates sent out during Bush Administration stimulus packages concluded that perhaps as little as 20% of that money actually flowed through into the real economy.



From 1969 through 1982, there were cyclical bull and bear markets within this time frame, but the period as a whole is referred to as a structural bear market since in 1982, stocks were at the same levels they had been at 13 years prior. The period from 1982-2000, the greatest bull market of all time, was the epitome of a structural bull market. In retrospect, it most certainly seems like another structural bear market started in 2000 when the technology bust took place because here we are, 9 years later and stocks are well below the high water mark of the bull market in early 2000. Looking back at roughly 140 years of stock market history, structural bear markets have lasted between 13-16 years and if the pattern remains the same, another few years of a structural bear market seem likely.

Nevertheless, it seems that monetary policy implemented by the Federal Reserve has been very successful thus far, whatever the long term inflationary concerns may be about the massive amount of liquidity being injected into the economy. Short term interest rates remain at zero and likely will stay there until the economic "green shoots" that have been referred to so often in the financial press show that they have spread their roots, or until Ben Bernanke is forced to respond to inflationary concerns by raising rates. The bottom line is that while the Fed has averted financial Armageddon, there is still wide disagreement about what a recovery from this financial shock will look like. Some strategists point to the fact that historically, sharp downturns have often enjoyed sharp recoveries. Others point out that we have never really gone on a years long credit binge of the magnitude that we saw during the housing bubble era and that it will take years for the deleveraging process to play out. The latter view would lend credence to predictions of a shallow, drawn out recovery where job creation would prove meager.

Structural bear markets can be difficult for the buy and hold passive investor, as many folks who have been invested in 401(k) plans over the past 10 years can attest. How do participants strengthen their portfolios to better handle a market with no clear trend but where money making opportunities still exist? One way is to follow the markets more closely and pay attention to how the different asset classes are performing. For example, small cap stocks and real estate investment trusts (REIT's) vastly outperformed large cap stocks during the period from 2001-2006 and an investor who was paying attention could have over weighted those asset classes and outperformed the broad market average by a substantial margin. For many of our clients, WESPAC recently introduced their collective investment funds into the investment lineup of your plans. The entire investment methodology underlying these funds is based on following trends within the market and preserving capital when the market weakens. Please do not hesitate to contact us if you have any questions about the new collective investment funds or if you would like to have a portfolio consultation.



We have talked about structural (or secular) bear and bull markets in these reviews before, and this may be a good time to raise the topic again. A structural bull market is a long term trend of rising prices while a structural bear is a long term trend of declining shares.

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.

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