

Economic Conditions & Market Outlook

Wall Street jargon has always been peppered with colorful market maxims. From pithy favorites such as, “Buy on the rumor, sell on the news”, “The trend is your friend”, and “Trees don’t grow to the sky” to more eloquent admonitions such as that of economist John Maynard Keynes who noted that, “The markets can remain irrational longer than you can remain solvent.” Though usually entertaining and periodically accurate, investors should never mistake these clever witticisms for financial corollaries based on today’s market reality.

This last fact became painfully clear to any investor who adhered to the old Wall Street adage recommending that one, “Sell in May and go away”, referring to the choppy performance and lackluster trading volume that frequently accompany the investment markets throughout the sticky months of summer. Heeding that ‘advice’ this year would have been very costly indeed since stock market gains during the past four months have accounted nearly all of 2009’s year-to-date positive performance in the major equity benchmarks.

From April 30 to August 31, the Standard & Poor’s 500, Dow Jones Industrial Average, and the NASDAQ indices logged appreciation of 16.94%, 16.26%, and 16.98% respectively. Market growth during these months pushed the S&P 500 and DJIA into positive territory for 2009, with year-to-date returns of 12.99% and 8.20%. The NASDAQ added to earlier gains and ended August up 27.40% from December’s close. This is the sixth consecutive month that the S&P 500 and NASDAQ have logged positive monthly results, with the DJIA just missing that achievement due to a slight dip into the red for the month of June.

However, it is important to remember that this string of monthly positive returns followed an absolutely abysmal start for 2009. January and February felt like a replay of last September and October, with markets falling as fears about financial bailouts, nationalized banks, failed automakers, and an expanding global recession reached a crescendo. Given the notable about-face since then, it is important to try to understand what factors contributed to this market turnaround and assess whether they are sustainable going forward.

As noted in May’s *Investment Update*, the stock market’s initial reversal from its low in early March was prompted more by shifts in investor emotion and attitude than by definitive economic facts and figures. Sentiment improved as the summer progressed, with more investors becoming convinced that the bounce in stock prices had some staying power and choosing to shrug off the lingering specter of a major market correction in favor of searching for long-term investment bargains. Solid corporate earnings in July and August further convinced equity investors that the risk of a near-term market meltdown had been mitigated.

Fixed income investors have also seen bond prices rebound since the beginning of the year as fears of expanding corporate bond defaults gradually diminished. The bond market illiquidity experienced late last year, and the dysfunctional bond pricing that resulted, crept back toward expected norms throughout the summer months. Unlike stock prices, most of which still have a long way to go before coming anywhere near previous highs; we suspect the bond price recovery from last year’s downward distortion is nearly complete.

While quantifiable economic factors did not initiate the current market rebound, these measures will ultimately play an important role in determining whether momentum can be maintained. We have often cautioned that changes in investment markets do not directly correlate with changes in the general economy and vice versa. Some of this disparity is because the investment markets attempt to price in today what they anticipate will be the economic reality of tomorrow. When economic data begins to support current market movement, there is a much higher likelihood that the pricing trend will continue. And some measures are now beginning to confirm what the market had previously anticipated – that the worst of this current economic crisis may be behind us.

For example, most economists suspected there would be a downward revision in the second-quarter gross domestic product (GDP) from the initially reported -1.0% to a more negative -1.5%. However, the revised data that was released at the end of August left the original GDP number untouched, leading some observers to suggest that the +2.4% GDP growth originally forecast for third-quarter of 2009 might even be a bit light on the upside. Regardless, indications are that the U.S. economy has already turned the corner and has likely been out of recessionary territory, i.e. GDP growth as opposed to contraction, since sometime mid to late summer.

The global economy is also moving in the right direction, with many countries exhibiting revived GDP growth after rebounding from economic downturns that were shorter and less severe than the one experienced stateside. Data released in mid-August indicates that Europe's two largest economies, France and Germany, returned to growth during the second quarter of 2009, surprising forecasters but mirroring a turnaround trend that has also been observed in China, India and elsewhere in Asia.

In addition to the broader GDP measure, several of the most stubbornly suppressed economic indicators are also improving and add support to the premise that the U.S. economy is currently on the mend. For instance, U.S. factory output increased in August, the first uptick in this metric since January 2008. In the report details, the Institute of Supply Management states that this manufacturing growth appears sustainable near term since inventories that have declined over the last forty months need to be restocked to meet growing demand.

Likewise, the long slumping housing market is finally showing signs of resuscitation, with July's new home sales climbing more than expected for the fourth straight month. Year over year, this monthly measure still lagged July 2008's results but the important factor is a steadying upward trend from January 2009's apparent bottom in new housing sales. The used home market is also moving in the right direction, with July's increase for nationwide used housing sales being the fifth positive move realized in the past seven months.

Also notable is that home prices measured by the S&P/Case-Shiller index logged a second straight month of gains, the first time this index has risen for two consecutive months since mid-2006. While the ongoing recovery in home prices will likely remain bumpy near term, it is noteworthy that this change in downward momentum is occurring even as buyers begin to emerge.

Other areas of the economy are providing additional evidence that the consumer is not as dead as many observers would suggest; rather they are just in need of sufficient price motivation to loosen their tightened purse strings. For example, while the merits and appropriateness of the Federal Government's funding of the 'Cash for Clunkers' program can be debated, the effectiveness of the resulting price reductions as an incentive for buyers to satiate their pent up demand cannot be argued. Data is also showing that low prices are slowly beginning to pique some interest in areas of spending most sensitive to consumer attitude, such as hotels and travel, although these economic segments are a long ways off from recovering from this recession's fallout.

Despite the likelihood that unemployment numbers will continue to worsen throughout the months ahead before showing signs of improvement, the recently released Reuters/University of Michigan consumer sentiment index showed a substantial upward move in September. This report came on the heels of a similarly positive Conference Board Consumer Confidence Index number for the month of August. While consumer sentiment indices are admittedly quixotic, when combined with other tangible economic measures, it appears that the pervasive sense of fear and foreboding felt earlier in the year has begun to diminish at many levels.

As the economy continues to show signs of improvement, debate now centers on what kind of recovery may be in store: a 'V' shape- indicating a rapid rebound to sustainable economic growth, a 'U' - indicating a lingering, drawn out period of economic mediocrity until sustainable growth returns, or a 'W'- indicating an unsustainable initial rebound of the economy which again collapses and regroups before finally returning to sustainable growth. All of these have historic precedence but given the depth, breadth and complexity of this economic crisis and recession, it is doubtful the eventual recovery will mirror any previous textbook pattern.

The Federal Reserve also has a higher expectation of returning economic stability than just a few months prior, with last week's 'Beige Book' summary showing stabilization or improvement in most of the nation's twelve Fed bank districts. Perhaps flush with his own renewed job security, in late August even the normally reserved Fed chairman Ben Bernanke offered his most optimistic outlook for the economy since the crisis began.

While recognizing this improvement, organization officials also cautioned, in typical Fed-speak style, that there was still “considerable uncertainty” about the strength of the growth it was projecting for next year and that the current economy is “still vulnerable to adverse shocks.” We don’t disagree with this cautious assessment but we also suspect that many of the reporting revisions that inevitably accompany a newly recovering economy may provide some notable surprises to the upside.

There are valid concerns over the possibility of revived inflationary pressures and overheated growth fueled by massive governmental stimulus spending that continues unabated even as the economy corrects but these are not the pressing concerns of today. The current Federal Reserve chairman’s prior actions demonstrate his admitted bias toward viewing inflation as the consummate economic bogeyman. Our hope is that the Fed’s vigilance on this front will have some influence in tempering the federal government’s financial largess before stimulative spending becomes part of the problem and not part of the cure.

In the meantime, economic growth measures will remain mixed as the U.S. economy gradually rights itself and observers will continue to muddle through a period of wondering whether the glass is half-empty or half-full. We suspect the latter. However, the current sense of financial ambiguity was exemplified by two stories published in the online Wall Street Journal on September 3, both reporting on the same retail sales data just released for the month of August. The morning edition’s story headline read, “Retailers Report Weak Sales for August”, while the afternoon’s headline for the very same information was, “Retailers Show Best Results in a Year.” As noted previously, the timing of movement in the investment markets is not inextricably linked to economic clarity. Perhaps for now, that is a very good thing.

Our Tactical Investment Stance

Roof Advisory Group’s disciplined investment approach emphasizes adding value to client portfolios while controlling downside risk. Strategies include clearly defining investment policy ranges based on each client’s specific investment objectives/risk tolerance, monitoring portfolio adherence to established benchmark parameters, and the ongoing evaluation of relative portfolio return.

Within this strategic context, the firm makes tactical shifts with changing market conditions to optimize client portfolio performance. While every client situation is unique, outlined below are a few of the tactics we are using in the current market:

- The increase to ***minimum equity*** level for portfolio allocations detailed in the last *Investment Update* continued through the summer as targets were ***raised in June and July*** to reach an allocation level of ***above mid-point equity***. Several ***highly appreciated individual equity positions*** were ***rebalanced to target in mid-August*** but, since then, most portfolios have again experienced collective appreciation that has taken them to a point slightly above their aggregate target levels.

- As always, ***diversification remains a priority*** in both stock and bond portfolio positions but, as suggested in the last *Investment Update*, ***unique opportunities*** in specific asset classes and slightly higher than normal sector weightings were utilized in ***capturing near term market appreciation***. Specifically in equities, this included the addition of several securities designed to ***temporarily enhance portfolio exposure*** in both the ***Mid-Cap asset class and Technology sector***. These additions may be readjusted as the opportunity matures.

Moving forward, we will continue to ***add or enhance positions*** in securities or sectors that are ***attractively underpriced*** and are ***poised to appreciate***. The firm continues to execute an active sell discipline but, as noted prior, temporary downward pricing moves in a security may be overlooked if that holding is viewed as a long-term investment opportunity.

- ***Very short-term and liquid fixed income*** investment levels have been ***significantly reduced*** and will ***remain below the norm*** due to low yields. Cash positions continue to be ***redeployed*** into ***high-quality bonds*** with improved yields or held in reserve for ***expanding equity exposure*** when deemed appropriate. As noted elsewhere, the appreciation realized from corporate bond prices returning to more normal ranges has likely run its course. A potential increase in tax rates may expand the attractiveness of municipal bond alternatives.

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