ROOF ADVISORY GROUP, INC.®
INVESTMENT ADVISORY & FINANCIAL PLANNING SERVICES

INVESTMENT UPDATE

May 2009

Economic Conditions & Market Outlook

There may not be much solace in the old axiom that, 'before things start getting better, they have to stop getting worse' but there is some truth. Yet a bit of comfort can be found in the fact that there are several tangible measures showing that the U.S. economy is now deteriorating less than it was just a short time ago, indicating that *some* of the worst economic news may indeed be behind us.

In addition to the numerical data, many intangibles are also critical indicators of, and contributors to, any sustainable economic recovery and long-term improvement in the investment markets. Human factors such as perception, sentiment, and confidence are all essential components in the successful functioning of a free market system. While more nuanced and difficult to quantify, these factors are also starting to look up; contributing to our overall present stance being categorized as 'cautiously optimistic'. Or perhaps instead 'optimistically cautious' - it depends on the data and the day.

A recent quote by White House economic advisor Larry Summers succinctly summed up what both the tangible and intangible measures appear to be indicating about the current state of the economy and markets; that the "sense of unremitting free fall from a month or two ago is not present today." We indeed concur with Mr. Summers' conclusion although we would likely disagree as to the most effective ways to perpetuate any nescient turnaround that may be in the offing. However, that is a topic to be addressed another day.

There is clear agreement that the current economic recession will not make some abrupt about-face. A confluence of factors far outside the norm contributed to the complexity and severity of this worldwide financial crisis and the recovery process will be neither quick nor linear. Economic data will also continue to be mixed into the foreseeable future. Similarly, any comparisons or projections extrapolated from previous recoveries need to be applied with caution due to the scope and uniqueness of the current economic scenario.

Given those caveats, we are indeed starting to see what the financial media has already referred to ad nauseum as the "green shoots" of a reviving economy. As noted, we suspect that this will not be a garden-variety economic recovery and will likely remain unpredictable throughout the months and years ahead.

No single economic indicator is screaming conclusively that we are out of the woods as of yet and a few measures still have a ways to go before looking even vaguely positive. However, many major indicators are indeed hinting that things have stopped getting worse or have even slightly improved. When viewed collectively, the glimmer of optimism that the economy is better positioned than it was just a short time ago appears to be justified.

For example, economic activity as measured by overall gross domestic product (GDP) declined 6.1% in the first quarter of 2009; an admittedly significant drop but less than the 6.3% decline experienced in the last quarter of 2008. While this back-to-back decline in GDP was the sharpest drop for two consecutive quarters in over fifty years, it is noteworthy that the GDP slide did not continue to accelerate at an expanding pace. The separate components of GDP that contributed to the recent quarterly decline also offer some important insight.

Much of the U.S. GDP's first quarter slide resulted from businesses cutting output and reducing inventory. Including March's drop, business inventories have now compressed for seven consecutive months, the longest period of inventory reduction since February 2001 to April 2002. Although reductions in output and inventory negatively impact the near-term GDP, these repositioning efforts by businesses in response to a contracting economy is actually positive long term since excesses in these areas can result in even more severe economic consequences if left unchecked. Likewise, a GDP decline driven by inventory reduction is more encouraging than a drop in GDP instigated by lagging consumer sentiment and flagging consumer spending.

On the consumer side, retail sales fell unexpectedly in April but the decline was much less than March's drop of -1.3%. This decrease followed retail sales numbers that rose in both January and February after moving downward for the last six months of 2008. Some of the early 2009 pop in consumer spending was due to post-holiday gift card redemption activity that has become the norm during recent years, so a subsequent decline in March and April is not too disconcerting. And the trend of a *slowing* decline is again a noteworthy positive.

Similarly, U.S. consumers have not been entirely moribund visa vie their purchasing activity, just more reserved and selective in what they buy. Sales at discount retailers such as Wal-Mart and Marshalls have continued to do well, lower-end department stores such as Target and J.C. Penney are seeing mixed results but high-end retailers such as Neiman Marcus and Saks continue to languish. Consumer reticence to make larger discretionary purchases in the current environment will likely continue near term, clearly hampering any possibility of a quick recovery in the housing and auto industries.

Additionally, accessibility to easy credit by marginal borrowers has been reined in by most lenders, technically reducing the pool of potential purchasers for big ticket items. While this may contribute to a slower-than-expected rebound in consumer spending in these areas, the recalibration of consumer spending expectations is indeed a long term positive for the economy since much of the financial mess we're digging out of was precipitated by the irresponsible lending of large amounts of money to individuals who could not possibly pay it back and secured by illiquid assets of highly inflated values. A recipe for disaster no one wants to repeat.

Despite the current reluctance of the U.S. consumer to spend big, consumer confidence has recently surged based on data from April's Conference Board report and May's widely-followed University of Michigan Consumer Confidence Index, with the latter reaching its highest level since September 2008. These measures should be viewed in relative terms and no one should mistake the U.S. consumer for being a wide-eyed optimist since sentiment is spiking up from historic lows but the reversal in trend is again noteworthy.

Consumers are not alone in sensing that perhaps the worst of the recession has passed. Data in the April 2009 Manufacturing ISM *Report On Business®* indicates that manufacturing activity across the country is still contracting but is doing so at a much slower pace than prior months. Featured commentary excepted from the ISM report actually noted some tentative positive changes in selective manufacturing areas, another good sign.

Similarly, April's survey of small business owners from the National Federation of Independent Business also indicated that responders thought the recessionary climate was finally beginning to thaw. Federal Reserve Chairman Ben Bernanke noted that the economic outlook has "improved modestly" since March month end, with the recent Fed report stating that there were signs the recession was easing and that the worst may be past.

Perhaps most prescient indicator is that the Wall Street Journal's recent survey of prominent economists indicated that the group has actually *raised* their consensus GDP forecast for 2009 and were projecting that the current recession will end by late summer, sooner than the turnaround time targeted in their previous release. Their consensus forecast is that slow economic growth would be measured in the third quarter of 2009, followed by gradual economic expansion at slightly more than 2% during the first half of 2010.

Two important economic measures will likely continue to lag through the remainder of the year; employment and housing. Unemployment numbers are a trailing indicator and any uptick in reported data will not be observed until well after the actual improvement has started to occur. However, it is probable that neither the reported data nor actual job gain will improve anytime in 2009. The pace of job loss has slowed but the U.S. unemployment rate hit 8.9% in April and is projected by the WSJ survey economists to reach 9.7% by year end. This unemployment measure may even continue to inch upward even after actual job losses end since the U.S. currently needs to add over 100,000 new jobs per month just to remain constant with population growth.

The housing market understandably continues to receive scrutiny since the real estate bubble, and subsequent bursting, dramatically impacted many areas in the economy. As a whole, housing data is unlikely to see any enthusiastic rebound in 2009. But it is important to note that broader housing indices are comprised of many smaller measures and the summary data may not always accurately reflect the tenor of the entire industry.

Case in point, the Commerce Department's recently released data showed that housing construction fell to a record low for the month of April, with permits for new building starts also plummeting to new depths. Yet results from the National Association of Homebuilders confidence survey in May showed an increase for the second straight month and indicated growing optimism among by the builders polled. Why?

One reason is that while the collective Commerce Department number was decidedly negative, much of that drop was due to a plunge in new multifamily/apartment starts. Construction of single family homes actually rose 2.8% in April, following a slight increase in March that came after a flat February. These are admittedly modest percentage increases but again the trend is in the right direction and that is clearly a positive change.

Home prices continued to fall based on the latest release (February data) of the S&P/Case-Shiller Home Price Indices, although it was the first time in 16 months that the report did not hit a new record low. The next release of the home price indices is May 26th and it will be interesting to see if the slowing trend holds. Economists from the WSJ survey expect housing prices to slide through year end but at a slower pace than earlier in 2009. While this home price decline will linger, a further slowing in deterioration would be positive.

Despite home price moves being an important component to examine when assessing the health of the overall economy, we tend to put less weight on the predictive value of this measure than do some other observers. Specifically, we don't see home price appreciation as the primary catalyst to an improving economy this time around. In fact, we would not be surprised to see this measure notably lag other indicators during the recovery.

For several reasons, we are also suspect of the long term correlation some observers make between housing price appreciation and rising consumer confidence. First, dramatic real estate appreciation/depreciation (similar to home foreclosure rates) has been a largely regionalized phenomena, with some geographic areas being significantly impacted and others not. Even the S&P Case-Shiller reports referenced above only track a 10 city and a 20 city metro-oriented database. Consumer confidence tends to be a much broader measure.

Second, as the now-deflated real estate bubble continued to expand, the boost in consumer confidence that was supposedly created by the 'wealth effect' of home appreciation was dependent on two factors that no longer exist today: easy credit and lax lending standards to readily access inflated home equity and the desire of the homeowner to over leverage their finances by taking on excessive debt.

In fact, we would argue instead that in the present environment any potential impact from 'wealth effect' on consumer psychology and spending behavior, positive or negative, would be influenced to a far greater extent by the changing value of an individual's investment/retirement accounts, a more tangible expression of worth.

There has been a multitude of major issues potentially impacting the economy and investment markets of late. From TARP, TALF, and health care reform to bank stress tests, automaker bankruptcies, and a porcine pandemic panic, the possible influencers of economy, market, and attitude have recently been vast and varied. It would be impossible to sufficiently address each in a single *Investment Update* but one issue in particular deserves brief mention here because of the potential near and long term consequences if not managed well.

How much, and in what areas, the government should spend taxpayer dollars is a topic for healthy political debate and disagreement. However, there is general consensus among most economists that unbridled government spending and ever-increasing deficit levels will eventually lead to very unhealthy consequences, including economic instability, growing inflation, weakening currency, and higher taxes to name a few.

Extraordinary times require extraordinary measures and the quick response of creative legislative and Federal Reserve policy initiatives has helped prevent this unprecedented financial crisis from damaging the economy and financial markets more than it already has. The challenge going forward will be maintaining the discipline to wean the recovering economy off the medicine it needed to get well.

Federal Reserve Chairman Ben Bernanke clearly understands this necessity and has consistently stated the Fed's intention to modify their stimulative stance as the economy stabilizes, well in advance of inflation rearing its ugly head. Unfortunately, legislators may be less enthusiastic about paring their pet programs.

While it is too early in the economic recovery process to begin aggressively dialing back across the board, it is not too early to reexamine and edit the hastily assembled $787 billion stimulus spending package approved by Congress earlier in the year. From its inception, many of the items in the package were specious at best in providing any direct stimulation for the crippled economy. And, given that to date only slightly more than 3% of the allotted funds from this legislation have been utilized, it is likely that the economy will no longer be in need of stimulation by the time the government gets around to providing it. Consequently, not only will the spending be unnecessary, it could very well be counterproductive to controlling the future inflationary concerns that are already vexing the Fed.

Looking specifically at the equity and fixed income markets, the same 'cautious optimism' applies. The recent reinvigoration of the U.S. stock market in particular deserves diligent cultivation and prudent pruning since we suspect that a few of the most rapidly growing "green shoots" there may turn out to be little more than weeds.

However, both equity and fixed income investments have continued to stabilize and improve as 2009 has progressed. The illiquidity and pricing anomalies experienced by the bond markets during the last quarter of 2008 are gradually correcting and, after falling off a cliff in the first quarter of 2009, stock index averages have rebounded to somewhat near year end levels. As of May 20th's close; the Dow Jones Composite was down versus year end, the NASDAQ was up smartly and the S & P 500 was at about break even.

As we've noted many times before, the economy and investment markets do not always march to the same drummer and it is likely that investor confidence and market performance measures will again lead the economic-based indicators in signaling the return of better financial times. In addition to some welcomed price appreciation in an oversold equity market, daily stock volatility is gradually beginning to retreat from the extraordinarily high levels experienced since last September. This is a notable positive and indicative that investor fear of wildly unpredictable market swings is finally starting to normalize. It is also indicates that some improving appetite for moderate risk and that price momentum may continue to swing upward as investors' dollars return to the market.

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:

• After drastically reducing exposure to a ***significantly below minimum equity*** level in February to ***protect client capital*** from very unstable conditions and the subsequent market plunge, our equity allocation was ***gradually rebuilt*** to its current ***minimum equity*** level via ***selective purchasing*** of targeted stocks and funds.

• ***Diversification remains a priority*** in both stock and bond positions but preference was given to those securities that were ***attractively underpriced.*** Moving forward, position additions will continue to focus on spreading risk via adequate portfolio diversification but ***unique opportunities*** that may be available via ***specific securities or sectors*** will not be overlooked. As always, portfolio sector weightings versus appropriate benchmark will be monitored closely but ***slightly higher than normal*** sector weightings may result if deemed to be ***particularly attractive near term***. Likewise, temporary downward pricing moves in a security may be overlooked if that holding is being positioned as a long-term investment.

• ***Very short-term and liquid fixed income*** investment levels have been ***significantly reduced*** as portfolio assets have been ***redeployed*** into ***high-quality bonds*** with ***improved yields*** given our ***less defensive posture.*** Money market fund exposure will likely remain below the norm for a while due to very low yields. Opportunities to ***augment municipal and corporate bond*** holdings in the improving market will be pursued.

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