



Q1 2009 Notes on the Quarter

Overview of the Quarter:

- 1) The first quarter was even tougher than the fourth quarter of last year: January was one of the worst on record. By the end of February, the S&P 500 was down more than 21%. More frauds were uncovered, more banks were closed, and the government spent money like it was... well, not water, because we are running low on that, but you get the picture. The good news was the markets all rallied early in March and continue to rally as of this writing. However, for the quarter the S&P 500 was down 11.7%.
- 2) The credit markets have started acting better. Yield spreads are still very wide, but there is no question that corporate and municipal yields are beginning to make better sense. There is still a ways to go, but spreads are tightening which is important and positive.
- 3) We are hearing reports on the ground that suggests housing prices are beginning to stabilize – another positive indication.

Portfolio Specifics:

- 1) While Q4 08 reflected panic, Q1 09 reflected a sense of depression and hopelessness. The markets simply became too pessimistic. The markets have become increasingly overly-optimistic, which indicates that 1) traders, not investors still control the markets (a bad thing); and 2) there is little clarity, which leads to these wild swings of opinion.
- 2) By adding heavily to fixed income securities while keeping a low profile in equities, we have kept portfolio volatility well below that of the broad markets. At the same time, when the markets got too depressed we bought, rather than sold, and have profited. As Kipling wrote, "If you can keep your head when all about you are losing theirs...." Perhaps he was a good investor too.
- 3) We stopped writing covered calls – getting the upside in stocks. We plan to start writing them again now.
- 4) The rally has not led to drop in volatility; the VIX still is up at 42, double where one would expect. This makes me less convinced the rally is for real. We continue to maintain a defensive posture.



Looking Ahead:

A month ago, the world was ending. Stocks had no value, bonds little value, housing prices were going to drop forever, and the world was going to go back to prehistoric times. Now, I love chewing on bones, and I will admit, my nickname has been “Caveman” for close to twenty years, but I really do not think saber-tooth tiger skin is about to come back into vogue.

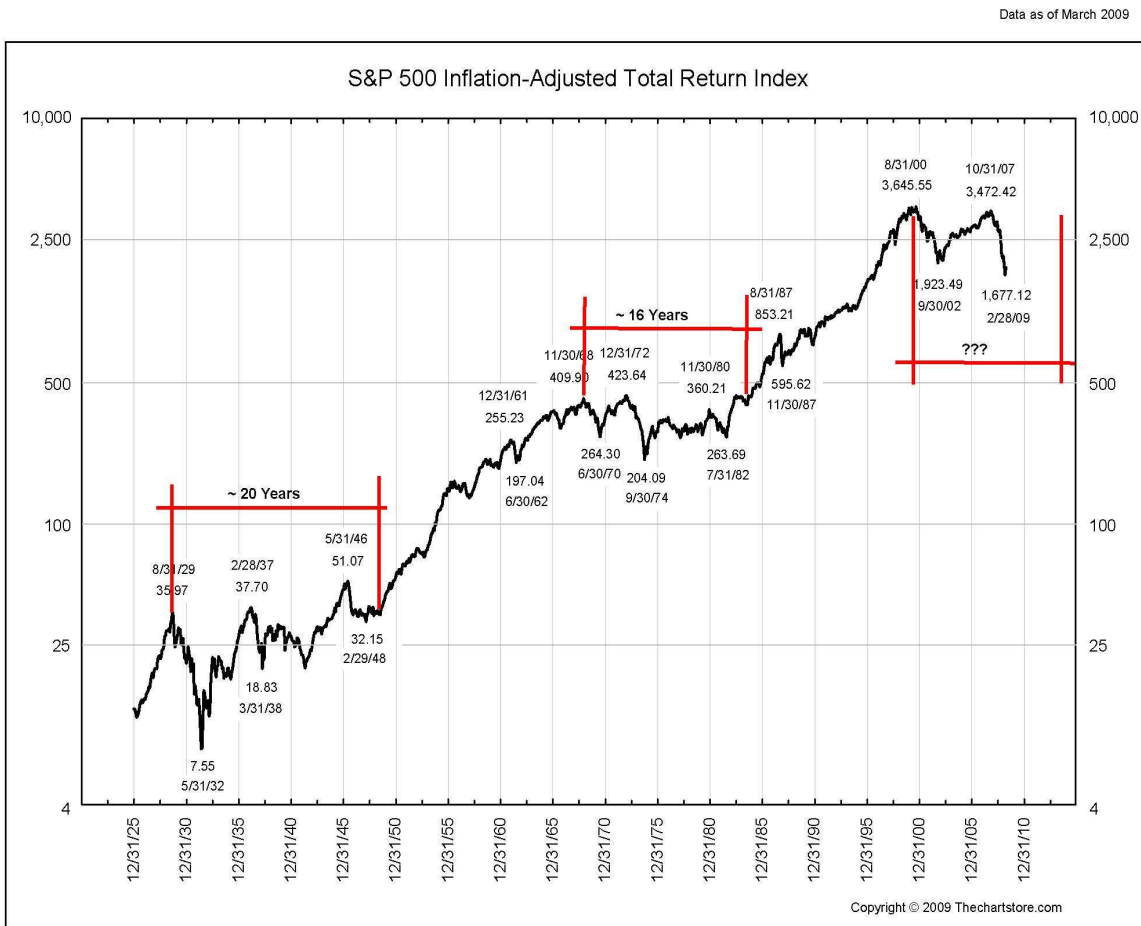
There is no question that there are still numerous issues that need to be addressed. Leverage is still high in the consumer and now government sectors, as well as at many of the large banks. Another rule change, this time to the mark-to-market rules, will make bank portfolios look better than they are. There is a good chance that the upcoming stress tests for banks will cause some problems too. Greed for money and power are still in control, and along with impatience, is leading to bad decisions, none of which helps stabilize the investment markets. The credit markets are acting better, but not by much. There is still a reluctance to lend, which is choking the world economy. The government’s answer, a spending deluge, thrown at anything and anybody who makes enough noise will lead to a weaker dollar and inflation.

However, not all of the news is bad. We are getting reports on the ground here in Phoenix (one of the worst hit residential real estate markets in the country) of a dramatic increase in contracts on homes in foreclosure and short sale at or below replacement cost. This does not mean that prices are about to rise, but that perhaps a low has been set. Whether or not we like the long term impact on inflation, there is no doubt that the government has spent enormous amounts of money in the past nine months; by one account, almost 12 *trillion* dollars (the US GDP is about 14 trillion)! Certainly some stocks seem (until the recent rally) to have been too cheap, often selling at or below book value. Bond markets are slowly getting stronger. There have been a number of new corporate and municipal offerings recently, and while spreads are still too wide, they are lower than they were just over a month ago.

So let’s try and put this all together.

Stocks: Stocks are starting to get more interesting, but we are not there yet. In fact, we are starting to take some profits from the recent rally and are going to start writing calls again. We believe that Wall Street is too optimistic about the economy turning by Q4 of 2009. Commercial real estate and credit card delinquencies still pose problems. In addition, for all the money Congress and the President have spent, it may turn out not to be enough (mostly because much of what is being spent is a waste). If we are correct, then the recent rally will fall out of bed. Everyone expects China to pull us out of the recession, but unemployment is growing very rapidly, and although they have reported a rise in manufacturing in March (the first time in six months), one month does not a trend make.

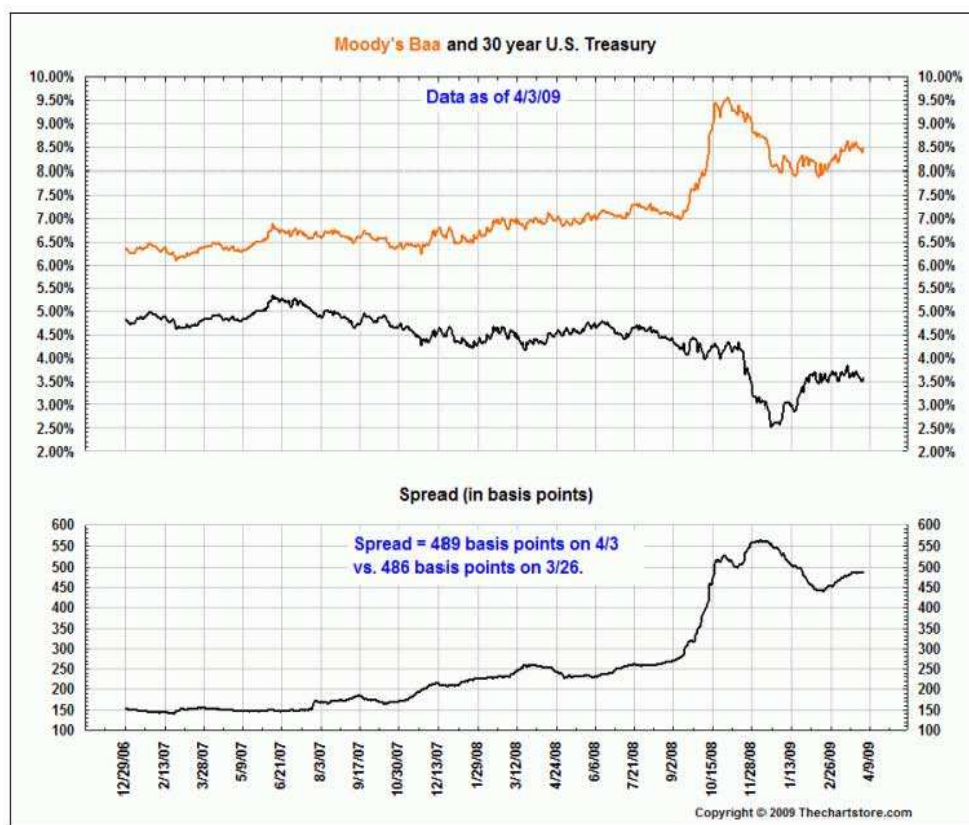
Looking Ahead (continued):



We believe, as we have stated a number of times, that the broad stock markets are likely to move sideways for a number of years (another five to ten years). This chart helps explain why. Inflation-adjusted values are too high and will likely be volatile but overall flat for some time, just as we saw in the 30s and 70s. Thus, stock picking will provide potentially better returns than the broad indexes. There may well be some violent rallies, but they will be followed by sell-offs until inflation-adjusted valuations (read P/Es) are lower (this happens first with lower prices and then with higher earnings without the stocks moving much).

Looking Ahead (continued):

Fixed Income: Inflation is coming. However, first the credit markets re-liquefy, which will require spreads between corporates, munis and treasuries to tighten, leading to profits in corporates and munis. Remember that the government is manipulating the treasury market by printing money and then buying treasuries (borrowing from Peter to pay Paul). Thus, treasuries will rise much more than corporates or munis will fall (in yield).





~ The Bottom Line ~

I could just quote last quarter's discussion as little has really changed. I believe that this year will continue to be difficult for the economy and volatile for investments. Diversification will continue to be critical.

Corporates in the 3-5 year maturity still look very attractive to us. For inflation protection (a matter of when, not if) TIPS and gold will be very attractive.

Short term we expect this most recent rally to roll over and turn negative, so we are planning several strategies: 1) selling covered calls on those stocks we like but think there is downside risk to; 2) hedges to protect portfolios from negative moves in the indexes; and 3) we will buy commodities, but due to a number of different indicators, think they will sell off first.

Long term, inflation is a big issue so building positions to protect against this will be important. Gold investments and TIPS are the best hedges. Whenever we get weakness in these areas we will add to the portfolios, continuing to building our exposure. In a couple of years, we are going to be very happy we had these hedges.

The increased inflation will be helpful to commodities as well, as long as the world economy hasn't collapsed. Even weak economies still need basic commodities and this means that emerging markets like Brazil should benefit. Whatever economic growth we see will likely come primarily from China and India because they do not have the leverage issues most of the rest of the world is attempting to deal with and they are still emerging economies.

As always, we want to thank our clients for their business and look forward to reporting to you again in July.

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