

## First Quarter 2009 Market Report

Monday, April 27th, 2009

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### **The Recession (cont.)**

The global economy finished the year's first quarter still firmly mired in recession, although the stock market had lifted from its lows visited in early March. By quarter-end, the S&P 500 had narrowed its yearly loss to -11.7%, with the Dow Jones Industrials slightly worse off, at -13.3%. Overseas markets in developed economies were off by comparable, mid-teens amounts, their negative returns exacerbated by the strong dollar. Emerging markets, following a horrid 2008, posted slightly positive results. Among bonds, broad indices posted break-even total returns.

In hindsight, it is clear that the failure of Lehman Brothers in September 2008 precipitated chaos in financial markets that threatened the integrity of the global financial system. In rapid order, businesses and consumers alike pulled back sharply from economic activity, worsening further the recession that was already unfolding. In the aftermath of the Lehman failure, several emergency stabilization and backstop measures undertaken by the government have greatly improved the normally unremarkable plumbing of the financial system. As markets have gradually stabilized, policy has increasingly been geared toward pro-growth measures.

The recession that is upon us is a deep one, global in scope, and with longer to run. The sense of pervasive freefall in the economy has been arrested, and the worst, most fearful moments resulting from the financial crisis have abated. (For now; this crisis has taught us all to expect the unexpected.) The government and the Fed are "all-in" with policy measures encompassing significant stimulus spending, interest rates that are near zero, and a mix of alphabet soup programs with acronyms such as TLGP, TALF, and PPIP intended to provide credit support and loans to the economy, to variously bolster financial institutions and encourage consumer spending.

### **Dispatches from the First Quarter**

The capital adequacy of the nation's financial system remains paramount to any sustaining economic recovery. With first-quarter earnings reporting for financials largely complete, a few trends are apparent. Importantly, financials are making good money on *new* business. The Fed has made the cost of funds for banks essentially zero, while also helping to engineer a comedown in mortgage rates. Predictably, loan demand, especially for mortgage refinancing, has picked up, at healthy margins for banks. Banks will replenish their capital and strengthen their balance sheets over time in this environment.

Also in the quarter, many banks benefitted from arcane accounting rules in their earnings prints. Wells Fargo, for example, was able to push much bad news from its acquisition of Wachovia “through the cracks” of purchase accounting. Several banks recognized earnings gains solely due to *decreases* in the trading value of their debt (presumably not a ringing vote of confidence from investors); accounting rules permit the borrower to take pro forma gains to the income statement. Last, a relaxing of mark-to-market valuation rules allowed many banks to value assets at more favorable prices, again affecting earnings for the better.

The financial sector is in a race with time and with the general economy. The dysfunctional, fear-soaked capital markets of last fall have receded. With a supportive Treasury and Fed, an accommodating yield curve, and stable deposits, banks are on an incrementally improved footing of late. The path of the general economy will mostly determine the fate of banks, and of their shareholders. Will fresh loans stay current (likely), and will legacy loans hold in, allowing the banks to preserve their thin capital cushions without dilutive financings (mmm...*maybe*). Stay tuned.

### **The Curious Case of Goldman Sachs**

Goldman Sachs, the Wall Street investment bank-*cum*-commercial bank, had a particularly eventful quarter, courtesy of perfectly-legal accounting cleverness. Formerly, Goldman had a fiscal year-end of November 30th, but its change to commercial bank status put it on a traditional calendar quarter for financial reporting. December, alas, became an orphan month. In early April, Goldman announced very strong results, posting net profits of \$1.7 billion that blew past all estimates. Pity December, however, a time when Goldman lost nearly \$800 million. This inconvenient footnote was all but ignored in the glowing financial coverage, and Goldman shares remained rock-solid, touching \$130.

Immediately following its earnings release, buttressed by its strong stock price, Goldman floated a \$5 billion stock issue, in part to raise money to repay the government’s \$10 billion TARP investment from last fall. Doing so will relieve the company from increasingly nettlesome government supervision, such as limitations on executive pay. Indeed, Goldman described its duty to repay TARP funds in patriotic terms. *Patriotic*.

Goldman executives were not feeling so patriotic on the matter of Goldman’s taxpayer-subsidized borrowings through the Treasury’s TLGP program, however, and have announced no intentions to repay this money early. These borrowings, totaling \$29 billion, are FDIC-guaranteed bonds issued by Goldman. They are a source of cheap funds for Goldman, with the taxpayer on the hook for losses in the unlikely event of a Goldman default. TLGP bonds do not come with strings like executive pay limitations attached. Goldman is content to leave these bonds in place. We will withhold comment on the patriotism of all this.

### **Investment Outlook**

Investors have taken comfort at the apparent stabilization underway in the economy. The economy is still contracting, but at a slower rate than prior (this phenomenon being the oft-cited, and seldom-explained, “second derivative”). Some economic indicators have very tentatively improved. The housing sector is at long last showing signs of life, as new supply has been sharply curtailed, and sales activity is picking up, as new buyers are snapping up foreclosure bargains. Recent durable goods orders have also suggested a bottoming-out underway in the manufacturing sector.

The economy remains in a fragile state, however, and is not out of the proverbial woods. A critical metric of health will be the future path of the nation's jobless rate. Unemployment is presently 8.5% and expected to worsen over the next several months, probably well into the period that the economy definitively turns for the better. Just as problematic are broader unemployment measures, currently registering nearly 16%, counting discouraged and under-employed persons. A prolonged weak job market will provide a significant undertow to recovery, weighing further on consumer spending and confidence, home prices and, ultimately, the soundness of the banks.

While we welcome the signs of improvement, and the upward turn in stocks, our professional skepticism remains heightened. The current market feels like a second marriage—the triumph of hope over experience—with stocks slightly ahead of themselves, relative to the state of health in the economy.

### **Equity Investment Strategy**

We put some of our year-end cash to work, and were net purchasers of equities in our **Quality Core** strategy during the quarter. We directed fresh capital primarily toward companies serving the energy, agricultural and metals markets. We remain underweight financial companies. Apart from short-term trading euphoria, we believe most financial and consumer-linked names will struggle for traction in the slow-recovery environment which we expect. We have edged toward an overweight position in the technology sector, which should be an early beneficiary of recovery.

We were also net investors in our dividend-focused **Equity Income** strategy. We have sharpened the portfolio's focus on secure dividends which we expect to grow, and our work has led us to companies in the defensive consumer staples sector, and to utility and telecommunications companies. The portfolio's underweight in technology shares (which tend not to qualify for inclusion in the strategy, due to their low dividends) has damped returns of late.

### **Fixed Income Strategy**

As noted earlier, a degree of normalcy has returned to credit markets following last year's chaos. Illiquid conditions have abated, and trading flows have been restored to most major segments of the bond market. The Treasury's extensive backstopping of lending markets can be credited as a success, by this standard.

Short-term money rates remain close to zero, and the Fed has announced that this will remain the case for the foreseeable future. Corporate yields, though historically wide to benchmark Treasuries, remain relatively low in the absolute, and credit-worthy borrowers have tapped the bond market at attractive financing rates, in some cases to lessen dependency on volatile shorter-term financing methods, such as commercial paper.

We remain purchasers of high-grade corporate debt, although we continue to avoid financial names. Our recent purchasing activity has been concentrated in the intermediate (i.e., 5-10 year) portion of the curve. The attractive rate backdrop has brought very desirable names such as Novartis, Cisco Systems, and Proctor & Gamble to the market, and to our clients' portfolios.

In the municipal market, we have continued to diversify away from solely New York issuance. With all new municipal purchases, we have focused extensively on general obligation (G.O.) bonds, underpinned by broad taxing authority to support debt service. We have avoided high-debt states with particularly noisome fiscal problems, such as California.

We view traditional Treasuries as a crowded trade. Given the combination of low current yields and an unprecedented flood of new issuance to finance the stimulus and bailout programs, we do not favor Treasury ownership in large amounts within client accounts.

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