QUARTERLY COMMENTARY
Third Quarter 2009

As we were writing our first quarter commentary just six months ago, economists and market analysts were speculating about whether the proposed government rescue efforts would succeed in keeping the financial system from collapse. Over the ensuing two quarters rescue money has significantly reliquified the banking system. The Federal Reserve has in essence dropped short-term interest rates to zero, which has allowed banks to take the free money and loan it back to the U.S. Government by buying Treasury notes and bonds. The difference between the zero cost and the yield on the Treasury paper is contributing to profit and rebuilding the banks' capital. Banks, hedge funds and any other financial entity able to borrow and lever up their investments can make this simple transaction highly profitable as long as the government makes taxpayer money available at essentially no cost. It is one major reason why so many complain that government efforts to date have rescued Wall Street with little benefit having filtered through to Main Street.

Admittedly, there is little potential for a broad-based economic recovery unless we have a functioning financial system. Because the rescue efforts have also improved investor attitudes, stock and bond prices have soared over the past seven months. This surge improves the likelihood that Wall Street firms will remain healthy, even if that same good fortune fails to extend to a broader list of companies.

An open question remains as to whether or not the economy will continue to improve once government stimulus stops and, worse yet, begins to be withdrawn. Optimists point to normal recoveries from past recessions that demonstrate consumer and business confidence growth as the recession memory fades. They anticipate that the worst is already over and that strong foreign demand, especially from emerging market countries, will supplement a normal domestic recovery and extend the positive growth cycle for a couple of years or more.

Pessimists argue that it's different this time. Notwithstanding government entities' questionable ability ever to get financial planning right, the bigger concern is whether or not the U.S. consumer will pick up the slack when the government ceases to serve as the buyer of last resort. What unintended consequences will government efforts leave behind?

We are in the camp of those who doubt the consumer will bounce back this time as readily as after prior recessions. The stock market losses of the past decade combined with the tremendous recent decline in residential real estate have carved a huge hole in the net worth of the average consumer. That consumer has been badly burned and has lost his/her long-held belief that investments only grow in value. Personal savings rates have begun to rise, and it is highly probable that erstwhile consumption will find its way into savings in the years ahead. Double-digit unemployment rates obviously impact spending by those who have lost jobs. The fear of unemployment in those still working will likely decrease their willingness to spend. And the need to rebuild nest eggs by boomers nearing intended retirement will almost certainly dampen their spending intentions.

This is not a typical recession, and the U.S. consumer is highly unlikely to bounce back in a normal fashion. Those who point to the Chinese or the Indians as the world's ultimate economic saviors are making a huge leap of faith. The Asian economies have grown and developed world-class strength as net *exporters*, not *importers*. It is unlikely that in the near term they are ready to replace the U.S. consumer as the buyer of last resort.

Worldwide government stimulus has slowed the economic decline and has led to improvements in most financial statistics. Many of those improvements, however, are in the form of slower declines, not actual advances. Overall economic levels remain extremely depressed.

On the heels of dramatic rallies, stock and bond prices are far from cheap. U.S. Treasury bond yields remain only slightly above half-century lows. Corporate and municipal bond yields have declined dramatically. We believe that numerous potential defaults in those latter categories make current bond prices highly suspect. By all traditional measures of value, common stocks are very expensive and are pricing in many quarters of strong corporate earnings growth. With tremendous fragility remaining in the financial system, we think this is a very dangerous time to pay a premium for assets that have already rallied strongly off their lows.

The past twelve months have seen some of the most remarkable stock market action in our lifetimes. Massive declines were followed by an essentially uncorrected rally that has seen most major stock market indexes climb by about 60% from their March lows. For the full twelve months, the S&P 500 recorded a loss of 6.9%. We avoided most of the drama, and our portfolios earned small positive returns. We protected assets well through the period of plummeting prices, then sold most of our equity holdings into this year's rally. That leaves us with an ultra-conservative position right now. While over the next several weeks we would trail a rally that continues without corrections, we are extremely well positioned to react to potentially sharp economic or market changes. In a highly uncertain and still dangerous environment, it is our preferred position.

A number of clients have indicated their appreciation of the investment updates I began to provide this quarter on ThomasJFeeney.com. Unlike most blogs, I am not dialoguing with readers. If you enjoy reading these quarterly commentaries, I invite you to review the blog site. On no set schedule, but at least weekly, I comment on economic or market conditions, offering our often non-traditional viewpoints, which are fully grounded in an understanding of what has represented good value throughout market history. Take a look.

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