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## A Special Report

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### *What Next?*

Given the tenor of the conversations I am having with clients, prospective clients, and colleagues, I think it is a fair statement that I can not recall a time with a more universally pessimistic sentiment permeating market participants and observers. The gloom is palpable. Lately, I hear (and overhear) a lot of random speculation in the financial media and within the populace at large as to where the global economy and the capital markets might be headed from here. The range of opinions expressed generally fall into three “camps”. A quarter to a third of the people I speak with seem to think the economy will continue to deteriorate in the near term, but that it will begin to improve by year’s end. Another group, probably half of the people I hear from believe that there’s at least a 50% possibility of things deteriorating into worldwide global depression. And the third group, certainly much smaller in number than the others, but fairly vocal nonetheless, see the current level of government intervention into the economy as “*the end of the world/capitalism/free markets/freedom*” as we know it. Of course, one’s predisposition toward optimism or pessimism has something to do with which camp one finds itself in, but there are few people who see a (near-term) light at the end of this tunnel.

**And I don’t blame any of them. I can fully understand the pessimism, and to a certain extent, I share in it.**

We have real economic dislocation and financial troubles in this country. I see it at every point along the wealth spectrum. No one has been spared. The difficulties have spread to levels unseen by all but the oldest among us.

The economic news is relentlessly reported and it is just as relentlessly bad. Concerns about the possibility of another Great Depression, or of this country going through what Japan did in the '90's are raised every day by the media pundits and talking heads, some of whom seem inappropriately gleeful as they report each depressing bit of data.

The truth is that this economy is at an inflection point. Decisions made over the next few weeks and months, and policies implemented over the next year or so will ultimately determine if enough economic stimulus and policy corrective measures have been brought to bear to stop the slide *before* it becomes a full blown depression. The ability of our elected leaders and their appointees to make wise decisions and to (relatively) flawlessly execute a clearly understood and agreeable strategy will determine how long this lasts and how bad things get. While I have great faith in the resilience of the U.S. economy and businesses, I do not take great comfort in our current leaders' "abilities" to get it right.

### **Reasons for Some Optimism**

Here are a few provided by Dr. James Paulsen, Chief Economist at Wells Capital Management, in a letter to advisors dated February 5, 2009. (*My comments are parenthetical.*):

- **Real Income.** The annual growth of real disposable income increased at a 3.3 percent pace in the fourth quarter, despite 1.5 million job losses. Credit the dramatic fall of oil prices for the gain. (*We will not benefit from a similar percentage decline in energy prices going forward.*)
- **Savings.** The personal savings rate of American consumers has risen from near zero to 3.6 percent. Greater savings are problematic for the near-term, but the de-leveraging of America is happening faster than many thought possible.
- **REFI Explosion.** Mortgage refinancing activity has risen to the highest levels since 2003, and accessing these historically low fixed rates provides homeowners an opportunity to *permanently* cut housing costs.
- **Consumer Confidence.** The University of Michigan consumer assessment of current conditions has risen from its low point in November, and is now on par with where it was last summer. The consumer's expectations index has also lifted off its low, and is now where it was last March. Confidence is still very low, but it has apparently bottomed. (*We have a long way to go to get back to reasonable levels.*)

- **Consumer Lending.** You wouldn't know it from watching or listening to the financial media, but consumer lending is improving. The percentage of banks more willing to make consumer loans, minus the percentage less willing to make consumer loans rose to -16 in the first quarter survey, recently completed. *(That means there are still more banks less likely to lend to consumers, but it is a big improvement from the prior quarter's result, when it was -50.)*
- **Housing Inventory.** There is still too much "inventory" of unsold homes on the market, but the number is improving. The available inventory of existing homes for sale on the market was at 10.6 months' worth of supply in November. December's number fell to 8.7 months' supply. Escalating foreclosures are quickening home price declines, bringing the S&P/Case-Shiller Home Price Affordability Index to a record high. This bodes well for continued absorption. *(Of course, another "wave" of foreclosures could bring the number right back up.)*
- **ISM Survey Bounce.** The Institute for Supply Management (ISM) Survey for Manufacturing in America rose to 35.6 in January, up from 32.9 the previous month. Numbers below 50 indicate contraction, so the number certainly isn't great, but the improvement suggests the contraction may be decelerating. The Non-Manufacturing Survey was 42.9 in January, up from 40.1 the month prior.
- **Leading Economic Indicators.** The Conference Board's U.S. leading economic indicators rose unexpectedly in January for the second straight month, following five consecutive months of decline. *(This is extremely surprising, given the Consumer Confidence numbers, but we'll take it, and hope that the leading indicators are indeed predictive.)*
- **Productivity Improves.** Despite very negative (-3.8%) real Gross Domestic Product (GDP) in the fourth quarter of 2008, non-farm productivity growth was 3.2% during the period.
- **Earnings.** With 424 companies comprising 93.56% of the market value of the S&P 500 Index companies having reported Q4 2008 earnings, "As Reported" Earnings are down (-67%) versus Q4 2007. Excluding financials, the numbers are still negative, but much less so (-5%). This earnings recession is highly concentrated in the financial sector. *(Unfortunately, the financial sector is probably the most important of all, and until we get the banks back to profitability and capital adequacy, not much else can improve.)*

- **Yield Spreads Decline.** Libor spreads, swap spreads, investment grade bond spreads and high yield spreads have all narrowed dramatically over the past two months from their widest levels in history. (*There is still a long way to go for these spreads to return to “normal” levels, but issuance has accelerated from a near standstill late last year, and we believe the trend will continue.*)
- **A Normalized Yield Curve.** The yield curve is steepening, with longer-maturity bonds paying higher yields. (*A normally inclining yield curve is good for banks and their profits.*)
- **The VIX Stock Market Volatility Index.** The “VIX” Index, a measure of the market’s volatility, has come down over the past few months. The Index fluctuated from a low of 18 to its historical high near 90 in 2008, but has fallen to 49 at Friday’s close. (*That’s still extremely high, but it has declined.*)

In addition to these statistical data improvements we have a massive infusion of fiscal and monetary stimulus underway, with more undoubtedly to come. The “efficiency” of the spending’s effect on the economy is questionable, and the subject of much debate, but \$2 - \$2.5 Trillion is nothing to sneeze at. It will have a positive effect on the economy.

There is also a little matter of \$8.3 Trillion sitting in checking accounts, savings, money markets and small CD’s currently. That is \$5 Trillion more than a year ago this time, and when it comes back into the equity markets, it will have a positive effect on prices.

### **Major Problems Remain**

Now lest you think I’m wearing rose-colored glasses, there are a lot of very serious issues confronting our leaders as they attempt to jump-start this ailing economy back to health.

- **Unemployment.** The “official” unemployment rate in the U.S. rose to 7.6% in January. There are 11.6 million people on the roles today. The “unofficial” unemployment rate, the number that would include people who have exhausted their benefits, or are “under-employed”, working part-time jobs or jobs for which they are overqualified is probably close to 14%. It will rise further.
- **GDP is Falling.** The country’s total productive output fell by (-3.8%) last quarter, following a (-0.5%) decline in the third quarter. Expectations are that the first quarter of 2009 will decline by perhaps as much as (-5%), and for revisions for the fourth quarter number to reflect a larger contraction than was originally reported. Virtually everyone believes the second quarter’s production will decline as well. Many believe all four quarters of 2009 will see declining GDP.

- **Banks.** Our banking system is bordering on technical insolvency. Although there have only been a relatively small number (14) of bank takeovers by the FDIC so far, there are undoubtedly more to come. Two weeks ago, Treasury Secretary Tim Geithner announced his plan to “stress test” banks to determine if additional TALF monies should be invested in their balance sheets. While he provided little granularity to the process and timing of such tests, the implication of the announcement is that some banks may be too far gone to help, and those would need to be dealt with by takeover by the FDIC and/or “nationalization” of the bank(s), a notion that sent financial stocks into a tailspin over the past ten trading days. Unless and until the Obama administration, its regulators and Congress figure out a plan to get the toxic assets off the books of these banks, it seems highly likely that at least a couple of the world’s largest banks will “fail” these stress tests.
- **Global Woes.** The rest of the world is just as bad off. Europe, Asia and the Emerging Markets around the world are coping with similar, if not worse dislocation. Iceland as a *country* is bankrupt. Switzerland has so much Swiss Franc – denominated debt outstanding from Eastern European creditors no longer able to make their payments, they are in danger of defaulting on their own debts.
- **Politicians.** In my opinion, politicians are in large part to blame. We could spend a lot of time looking back at poor decisions made by Congressional “leaders” (and I use the term pejoratively) regarding mortgage regulations and underwriting. We could point to their inaction when the problems we face now first became known, but were still small enough in size and scope to do something about it. Or we could turn on our TV’s to watch the embarrassing political posturing on both sides of the aisle seen every day in Congressional hearings. The incompetence, selfishness, and lack of accountability are a national disgrace, but, as it has been said many times, we get the politicians we deserve. I have very little confidence in our current Congress’ ability to address our challenges with any bi-partisanship, and even less in their ability to do so in a fiscally responsible and efficient manner. They waste time and our money, which is what they do best.

### **What’s Next for the Markets?**

The past sixteen months have seen equity markets ravaged and investors’ confidence has been decimated. The demand destruction our economy is experiencing has been transferred to investors’ psyches, many of whom will *never* return to the equity markets. That’s the really sad part about all of this. Many investors have become the victims of poor policy decisions made by others, and these well-intentioned investors far outnumber those who were allegedly victimized by Bernie Madoff or Alan Stanford.

While it is obviously impossible to predict with any certainty the timing and direction of the equity markets near-term, we do believe a rebound is approaching in the near-to-intermediate future.

Why is that you ask? Well for a lot of the reasons I've already listed, much of the damage has been done. We've seen markets shave 40% - 50% off their prices already. Unemployment is high and rising, but lay-offs have the effect of cutting corporate costs and increasing earnings. Even well-run and profitable businesses are cutting back and eliminating waste. While the Obama administration has made some communication missteps in the past two weeks, I believe they've learned that the markets want details and granularity, not just platitudes and campaign slogans. I expect we'll hear more about their plans for banking reforms and remedies and on foreclosure assistance in the coming weeks. Expect a *lot* more money to be allocated to these two areas as everyone is finally at the point of agreement on the priority need to "fix" banks and housing. I am hopeful the temporary repeal of the "Mark-To-Market" accounting rules is forthcoming.

Please don't misunderstand. **I am *not* predicting an immediate bounce off the current market levels.** The day-to-day machinations of the markets and the exogenous events that affect them are impossible to predict. We could remain mired in the trading range (7100 – 9000 on the Dow, 740 – 900 on the S&P 500) we've been stuck in for the past three months, or we could easily see a breach of those lows and fall as much as 10% - 20% from current levels, which would put us at 6000 Dow and 600 S&P 500, levels not seen since October 1996!

However, nobody can convince me that the economy we have today, \$14.28 Trillion in size, should have its public companies priced as they were in 1996, when we had GDP of only \$7.82 Trillion. Although our population has grown from 266 million at the end of 1996 to 306 million today, we have almost *doubled* our country's output over that thirteen year period. Our government's intervention and policy response, while poorly communicated and inefficiently implemented, is the opposite of that of the government's in 1929 when faced with similar crises. **I believe that a "relief rally" will commence at the point that it becomes clear that this is *not* the Great Depression II.** That rally will be fueled by millions of investors who are tired of earning (virtually) nothing on their savings, and historically, these post-recession equity rallies are powerful, with movements averaging 30% - 40% off of the lows. I don't know which direction the next 10% move will be in the markets, but I feel fairly confident that the next 30% - 40% movement will be upward in direction. Given the fact that we've taken the losses to this point, we *must* be there for the inevitable rebound.

### ***How Do We Position Our Portfolios?***

I believe we have learned some valuable lessons from the crash that's just occurred. Diversification *beyond* traditional asset classes is required, since previously low-correlated asset classes failed to provide adequate protection from the downturns in equities. While we want to hold our current equity allocations now, in order to get the rebound we believe is coming, we will be using a potential rise in prices to lighten up our equity exposures in all but the most aggressive investors' portfolios.

It is now our belief that the economy will be relatively weak for some years to come, owing to the second-order effects of the massive (borrowed) stimulus spending we see today, and the strategic missteps of our government leaders over the past few years. The massive federal deficit that has ballooned to previously unthinkable levels, coupled with the still unaddressed problems of looming (and ballooning) entitlement spending (Social Security, Medicare, Medicaid) the baby boomer generation will require over the next decade leaves us with little hope for balanced budgets anytime soon. The inflationary aspects of all this borrowed money will undeniably appear in a couple of years, regardless of the level of economic recovery it may produce in the short run.

While we wait for equities to rally, we are tactically overweighting certain client portfolios to take advantage of some near-term opportunities prior to redesigning allocations much more strategically after equities rebound. Some of these strategies are being implemented today, and others will begin to be executed when the Dow and the S&P rebound at least 20% from current levels.

Here's where we're headed.

- **Debt is the New Equity.** In recent months, we've tactically re-introduced investment grade corporate bonds, and to a lesser extent, high yield corporate bonds into client portfolios. We believe that the historically wide bond yield spreads we see today are unsustainable, and despite the continued poor economic data, spreads *have* narrowed in recent weeks and months. We believe spreads will continue to narrow as economic data (and equity markets) improve, and credit becomes more readily available, presenting opportunities to make equity-like returns in bonds, with greater protection in the capital structure. We will avoid bonds issued by banks for obvious reasons.

- **Managed Futures.** This is an asset class we employed in many client portfolios back in 2002 – 2006, abandoning it due to clients' dissatisfaction at having low to mid single-digit returns during double-digit equity markets. These investments performed well last year, and when the negative correlation to stocks is considered, we think these investments should be re-introduced into many of our clients' portfolios in the very near term.

- **Market Neutral Investments.** There are a number of market neutral funds we have positioned in "qualified" portfolios in recent months. These funds utilize hedging techniques to minimize the effects of market downdrafts. These funds typically don't have tremendous upside movements in an equity rally, but they play an important role in sideways to down markets. We will continue to add them to client portfolios slowly, with more being added in place of long-only equity managers when we believe the equity markets have rebounded sufficiently.

- **Inflation Benefiting Investments.** While we believe that inflation is not a very near-term phenomenon to be concerned about, it will be in the coming years. We will want to position clients' assets to take advantage of that environment. Precious metals, commodities, TIPS, and real estate come quickly to mind as asset classes that can provide a hedge against the erosion of a portfolio's purchasing power. We will begin introducing these investments into client portfolios when the economic conditions improve enough to warrant a resurgence of incipient inflation.

- **Private Equity.** Historically, private equity investments made in periods of poor public market conditions have delivered investors their highest returns, since "investor demand" for equities (public or private) declines in such periods, allowing private equity program syndicators to drive better bargains for their investors. When stock prices are high, private company management has better leverage to demand higher prices for their companies. For qualified investors with appropriate time horizons, we believe professionally managed private equity investments will yield exceptional returns.

- **Insured Products.** Insurers have developed sophisticated products containing income guarantees ("living benefits") to investors wishing to re-insure their market risk for income producing purposes. These products can guarantee minimum lifetime income benefits, and we will introduce those issued by the largest, and most well-capitalized insurers to clients in need of such guarantees.

**- Dynamically Managed, “Trend-Following” Strategies.** For a small portion of a client’s portfolio, especially those held by investors who simply do not have the time frame to afford another lengthy or protracted market downturn while they are in income distribution modes, we will seek managers who have demonstrated abilities to avoid market downturns using “trend-following” signals. While we have never been a believer in market timing, or in anyone’s ability to anticipate a market turn, we have seen evidence in recent months of managers who have minimized the losses by using technical indicators as “buy” or “sell” signals. These managers never catch the bottom, and they never get the top, but they do tend to do well when trends (up or down) are prolonged.

There are a lot of products being developed in these “alternative” areas right now, as the demand for them is (obviously) increasing. We are developing a list of products and managers in each of these areas, and we will be sharing these ideas with qualified clients where appropriate over the next few months. In a perfect world, the equity market rebound we expect would begin in the next few weeks and months, and would last long enough for us to contact all of our clients with revised strategy allocations that would be ready for implementation as we begin to sell stocks “north” of Dow 9,000. Our goal would be to maintain our portfolio’s “expected” returns, but with much lower exposure to equities, as we believe 2010 and 2011 will bring inflation and other systemic problems related to the policy missteps we’ve previously discussed.

There are opportunities in every market, and especially so when markets are oversold or overbought at each end of the extremes. We remain firm believers that there is a capital market hierarchy of returns, led by stocks and other equity investments. We just believe that greater diversification by asset class will be required to garner the returns our clients need to meet their needs.

As always, please feel free to call me with questions or if we can be of service.

- JRP

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Alternative investments such as Managed Futures, Market Neutral Investments, Inflation Benefiting Investments, Private Equity and Trend Following, involve specific risks that may be greater than those associated with traditional investments and may have specific suitability requirements. You should consider the special risks with alternative investments including limited liquidity, tax considerations, potentially speculative investments strategies and different regulatory and reporting requirements before investing. Guarantees on insurance products are based on the claims-paying ability of the issuing insurance company. There may be additional fees and expenses for Living Benefit.