

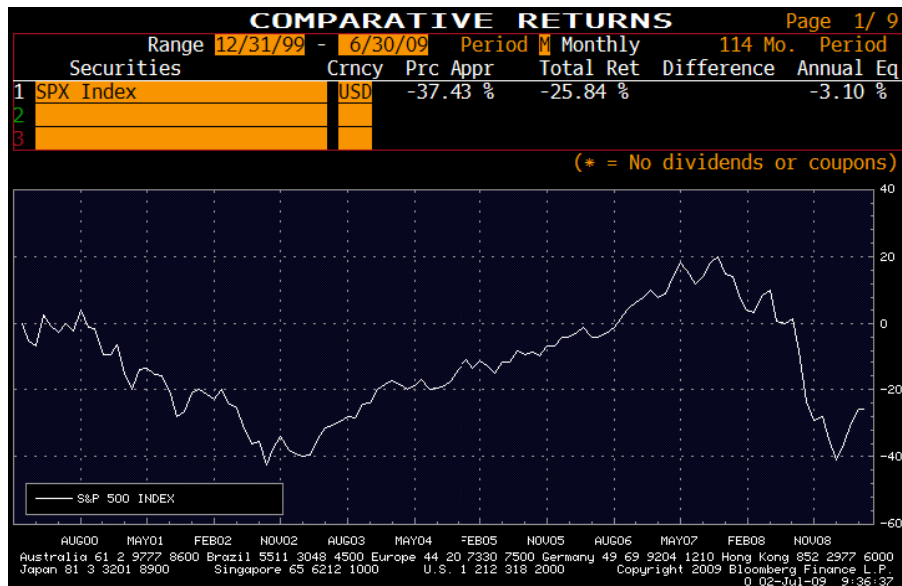
A Special Report

July 9th, 2009

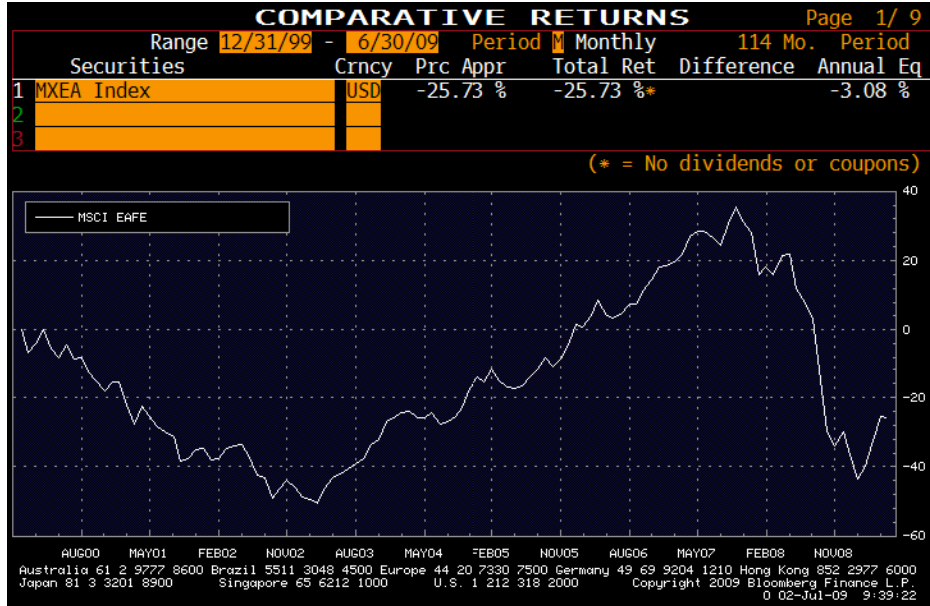
The Lost Decade, and the “New Normal”

As we approach the end of the first decade of this new millennium, a review of the performance of the equity indices since the turn of the century is in order. (I warn you, the data you are about to see should not be viewed by those with queasy stomachs or weak hearts.)

Domestic “large cap” equities, as represented by the Standard & Poors 500 Index (below), have spent most of this decade in a net loss position relative to the index’ starting value on January 1st 2000, and remain more than 20% below that reading today, with just six months left in the decade.

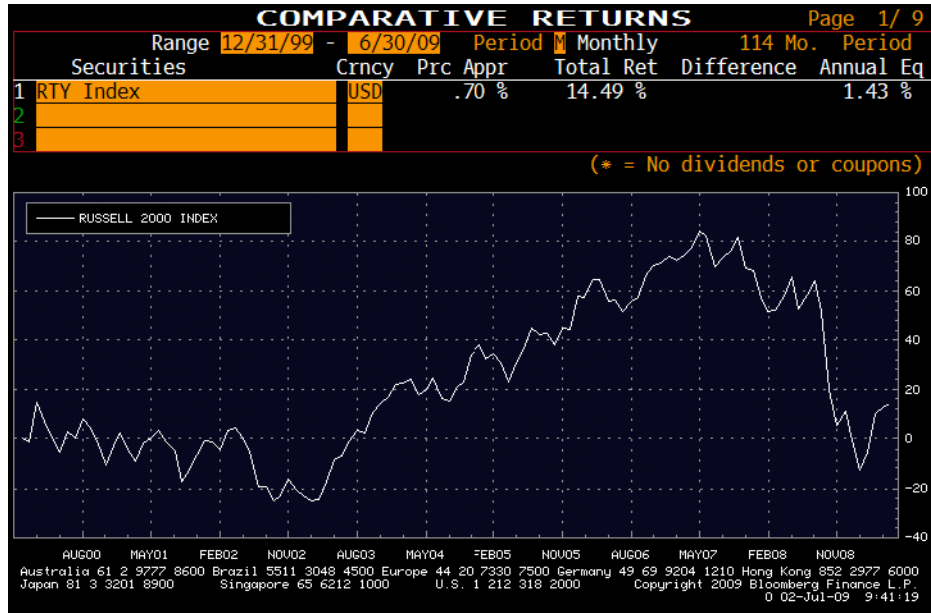


Developed foreign stock markets, as represented by the MSCI E.A.F.E (Europe, Australia, and Far East) Index, sit with approximately the same net loss for the decade-to-date.

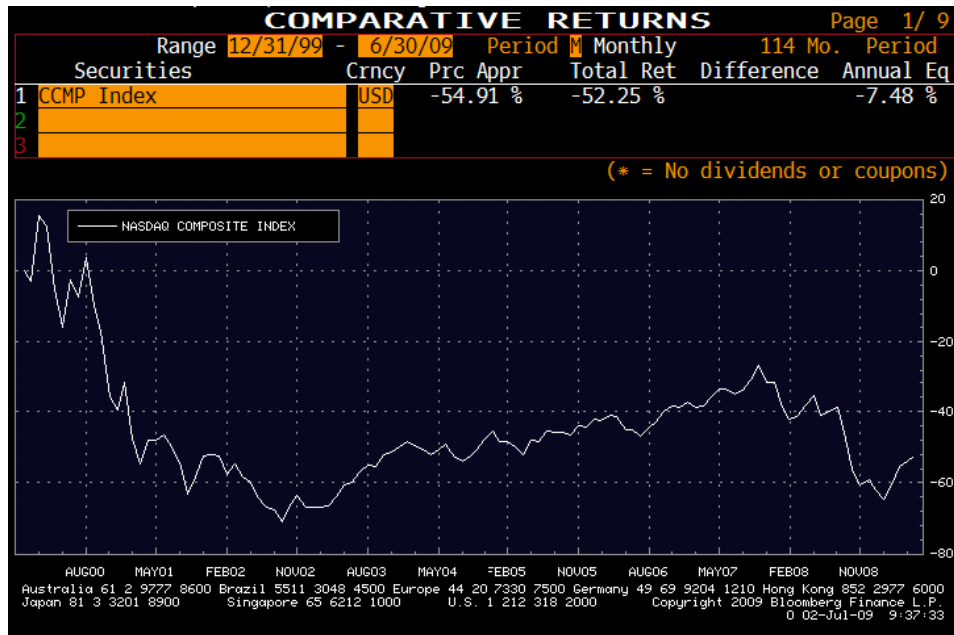


Domestic “small cap” stocks, as represented by the Russell 2000 Index, have been the best performers for the decade, at one point having delivered appreciation of 80%. But they gave all of those gains back in the most recent market decline, and have only recently climbed back into net positive territory.

At the beginning of this decade, how many among us would have guessed that an annualized 1.43% gain would have been the equity markets’ “leader”?



By far the “biggest losers” for the decade are the companies that make up the NASDAQ Composite Index, still reeling from a 75% “peak-to-trough” decline suffered in 2000 - 2002.



Lacking a major move upward in the equity indices during the last two quarters of this year (something fairly few prognosticators are predicting), we are looking at the worst decade in the stock market since the 1930's, and the first decade in seven to deliver a net loss.

The Dow Jones Industrial Average Returns by Decade (1)

Decade	Ending Value	Total Return %	Annual Average %
1890's (2)	66.61	62.70%	15.39%
1900's	99.05	48.70%	4.05%
1910's	107.23	8.26%	0.80%
1920's	248.48	131.73%	8.76%
1930's	150.24	(-39.54%)	(-4.91%)
1940's	200.13	33.21%	2.91%
1950's	679.36	239.46%	13.00%
1960's	800.36	17.81%	1.65%
1970's	838.74	4.80%	0.47%
1980's	2,753.20	228.25%	12.62%
1990's	11,497.12	317.59%	15.36%
2000's	8,447.00 (3)	(-26.53%)	(-3.19%)

Source: www.analyzeindices.com/dowhistory/djia-100.txt

Footnotes:

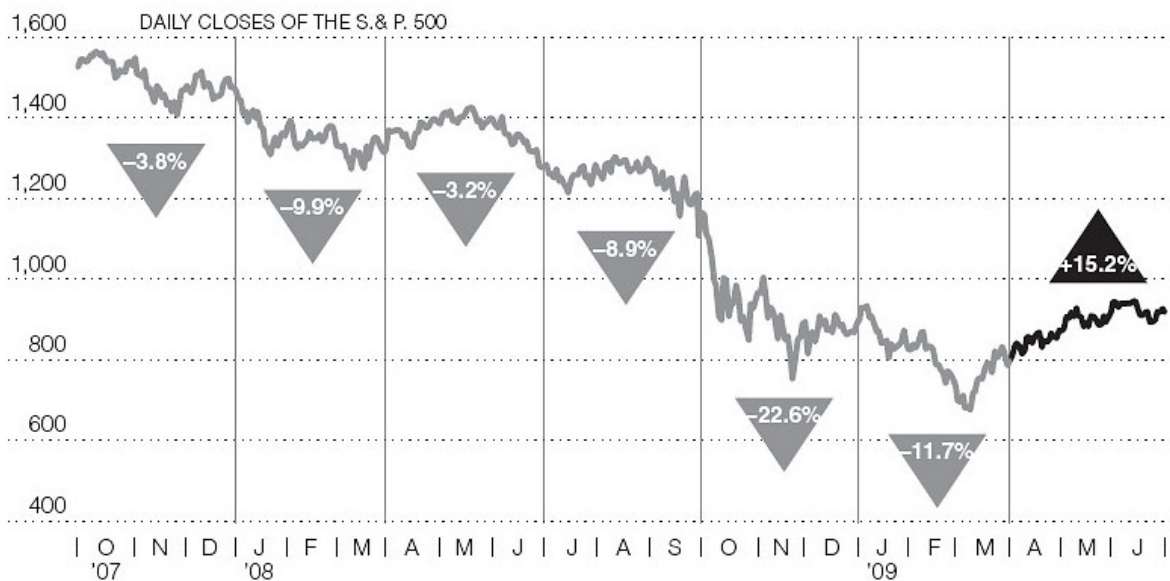
(1) The Total Return % shown for each decade, and the Annualized Average % are reflective of the Index' change only, and do not include dividends paid.

(2) The Dow Jones Industrials were first created on May 26th, 1896, with an Index value at creation on that date of 40.94. Returns shown for that decade are for 05/26/1896 – 12/31/1900.

(3) Ending value shown is for 06/30/2009. Returns shown are for the decade through that date.

Despite the recently – completed quarter's uptick in the equity markets, the past seven calendar quarters have decimated investors' returns for the decade....

After six quarterly declines, the Standard & Poor's 500-stock index rose in the second quarter.

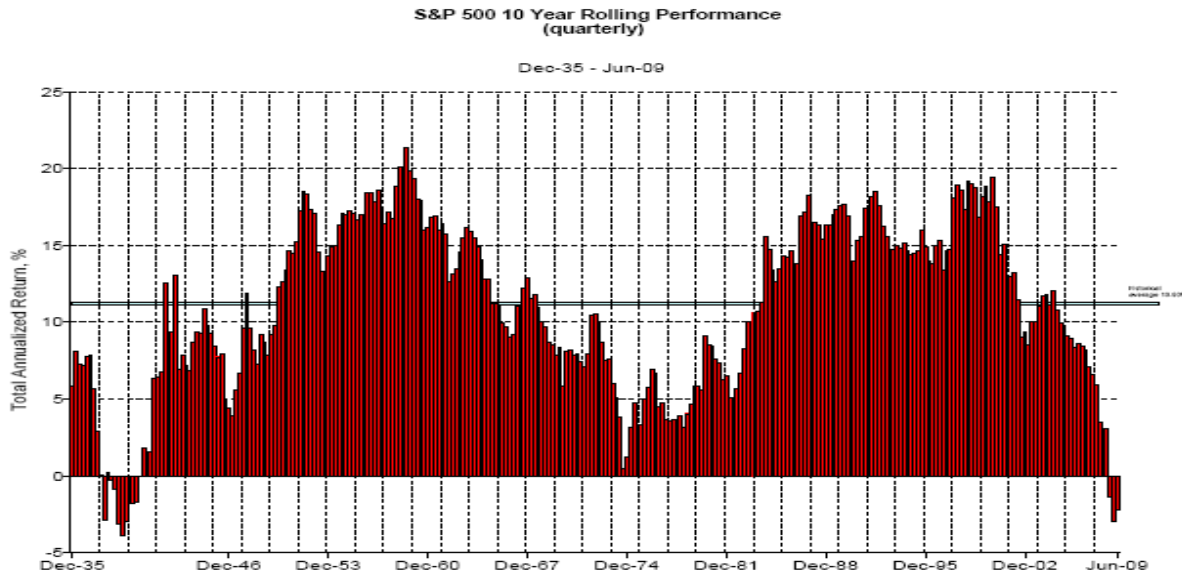


Source: Bloomberg

THE NEW YORK TIMES

Source: NY Times

....and, finally, looking at “rolling ten years’ returns” on a quarterly basis, we will be looking at an extremely rare annualized loss of 2% - 3% per year for this “*Lost Decade*” if things don’t rapidly, and dramatically improve. You’ll note that the last time we posted annualized rolling ten year losses for multiple quarters was the period immediately following The Great Depression.



Source: Standard & Poors

The phrase, “*the Lost Decade*” has become part of the American lexicon over the past year or so, as financial writers and media commentators have inundated us with any number of “causes” or culprits upon which to place blame for the markets’ incredible collapse, most of them ultimately related to an under-regulated financial system, and/or an over-leveraged economy in general. This recession is by far the worst experienced in America since the aforementioned Great Depression of the ‘30’s, and the consumer demand destruction that has taken place as a result, along with the loss of investor confidence, is enormous in scope. In my twenty-seven year career, I have never personally or professionally seen investor sentiment at readings as low as are commonplace today. Economic and market losses of this magnitude have, in my opinion, placed us in a position where the inevitable economic recovery (yes, I still believe recovery is, in fact, *inevitable*) is likely to be tepid at best, and we believe investors (and advisors) should begin managing their expectations for the near-term future around a “*New Normal*”, an economic and market recovery that will not return to “pre-crash” levels any time soon.

Why so pessimistic? Let me count the ways...

- Gross Domestic Product has fallen by annualized rates of (-0.5%), (-6.3%), and (-5.5%), for the three consecutive calendar quarters ending March 31st, 2009. According to the U.S. Department of Commerce’s Bureau of Economic Analysis website (www.bea.gov), which posts quarterly GDP data back to 1947, these three quarters were the worst three consecutive quarters’ percentage declines recorded. The second calendar quarter’s (period ending 06/30/09) GDP number will most certainly also be negative, adding to this extraordinary decline, and economists today are debating whether a positive number’s arrival can reasonably be expected *before year’s end*.

Regardless the date the current contraction in economic production actually ends, few credible economists are predicting a traditional “V-Shaped recovery” that would relatively rapidly bring the country’s cumulative economic production back to its pre-recession levels. My prediction for *full* economic recovery? Perhaps mid-2011, but likely later.

- Corporate earnings have absolutely cratered. According to Standard & Poors, “*Operating*” Earnings for the companies that make up the S&P 500 Index fell by a whopping (-43%), year-over-year for the four quarters ending 03/31/09, and “*As Reported*” Earnings fell by an incredible (-89%) for the same period. The recently ended calendar quarter’s (06/30/09) earning reports will begin trickling in next week. Standard & Poors projects a 30% increase in Operating Earnings this quarter over last, and that would certainly be a welcome reversal of trend. That increase is the “consensus estimate” routinely cited within the financial media, but even if they’re correct, nominal dollar earnings will still only be back to 2003 levels. If earnings announcements “disappoint” market participants, as they have the past several reporting periods, the markets *will not* respond well.
- The “official” unemployment rate in this country stands at 9.5%, and is likely to continue to grow well past 10% before it stops rising, probably sometime early next year. This is the highest recorded national unemployment rate since 1983. Depending on who you listen to, the “unofficial” unemployment rate, which would include “under-employed” workers, those earning less than their qualifications and past employment would suggest they are capable of earning, and workers who have simply given up on finding gainful employment, may be “north” of 15%. The Personal Savings Rate of American consumers, a number that went negative earlier this decade, meaning Americans were for a time spending 100% of their earnings...*and then some*, has spiked to 6.9%, a percentage not seen since the early ‘90’s. While personal savings is a good thing in normal economic environs, right now the economy needs the consumer to *spend*, and that clearly isn’t happening.
- Despite the ad campaigns the banks are running at the moment, they simply are not lending to consumers or businesses, at least not at a level that would lift this economy out of its doldrums. Bankers are unwilling to risk further defaults in their residential mortgage portfolios, and are requiring much, much higher levels of equity investment from buyers, especially in “jumbo” loan situations. They also cite growing fears of defaults within their credit card and commercial real estate loan portfolios as well.
- The Federal Government projects a \$1.8 Trillion fiscal deficit *this year*, easily an all-time record by any measure, and the new Administration’s proposed spending policies in the areas of *Health Care*, “*Clean*” *Energy*, and *Education*, if enacted, will *add \$1 trillion per year* to the cumulative deficit *for each of the next ten years*. As I mentioned in my last report to you, spending at these levels cannot be funded by increased taxes on the wealthy alone, nor can it be financed through the sale of Treasury debt, as the market demand for Treasury debt is a fraction of the need, so it would have to be met by the printing of trillions of dollars by the Fed. An increase in the money supply of that magnitude would almost certainly result in a devaluation of the dollar, and could lead to inflation levels not seen since the late ‘70’s.

I could go on and on with depressing economic data points, but you’ve likely heard them ad nauseam, and I suspect that this is not “news” to you anyway.

There are some bright spots and there are certainly some reasons for optimism *over time*, so for the sake of providing equal time, let me elaborate on several of those.

- The Federal Reserve is, in my opinion, performing about as well as could be expected in these difficult times. Chairman Bernanke is, in my opinion, doing a masterful job of managing the more immediate risk of deflation with the Fed's Quantitative Easing, and I sleep better at night knowing he's at the helm of the Fed.
- The equity markets, still down well over 40% from their previous highs, have *fully priced in* the current economic downturn, so lacking more economic disasters, further declines should be more muted. In my informal surveys of money managers, there seems to be a belief that "fair (fundamental) value" on the S&P 500 would be somewhere north of 1000, or 20% higher than current values, if the markets weren't behaving so irrationally. (Unfortunately, the markets' irrationality is a fact of life today, so fundamental valuations are effectively irrelevant at the moment.)
- The U.S. economy is leading the developed world out of recession. We were first to fall into recession, and will likely be first out of it. As I stated earlier, I truly believe that economic recovery is inevitable. In truth, the question is *when*, not *if*, the economy will fully recover.
- Finally, there are traditional and non-traditional markets and strategies that are doing relatively well in this downturn (i.e. corporate and high yield bonds, managed futures, certain commodities, market neutral funds, absolute return strategies, etc.), and we have diversified many, if not most of our clients' portfolios toward greater exposures to these asset classes in recent months.

In closing, let me state the obvious, and remind readers that we are living in times of virtually unprecedented challenges. The obstacles facing our economy are daunting, and for most of us under the age of 70, unseen in our lifetimes. Looking back with 20 – 20 hindsight, it seems obvious to us now that there were fissures and cracks in our country's economic underpinnings that were visible to the naked eye years prior to the dam bursting.

Consumers were leveraged to unsustainable levels, and few of us in American society were disciplined enough in our personal spending and lifestyle habits to avoid a painful deleveraging process. For some, this will be a catastrophic process. Businesses were over-leveraged as well, and those that cannot "right-size" quickly, and nimbly reallocate finite resources will likely suffer a difficult and potentially "fatal" (to their enterprise) outcome. The strip malls and office buildings are littered with companies that simply underestimated the depth and duration of this downturn, and lacked sufficient resources to survive it. And finally, government provided woefully inadequate leadership in the areas of fiscal restraint and responsibility in the years (and decades) leading up to this crisis.

The "good news", if one can call it good news, is that we are entering a new era where consumers will have to find ways to live well within their means. Living within one's means lends itself to a far more sustainable growth over time. Easy credit was, in the end, an evil thing. It is now a thing of the past, and I seriously doubt we will see its return anytime soon. Businesses likewise will have to re-invent themselves, rediscovering ways to efficiently deliver goods and services at a profit.

I am a great believer in the American capitalistic system, in the profit motive, and in the “animal spirits” that John Maynard Keynes referred to in his writings. We will survive, and eventually, we will thrive. In the near-term, we’re just going to have to be much more active, more defensive, and more tactical in our approach to investing resources. The goal in a secular bear market such as the one we’re enduring is to advance whenever possible, and protect whenever necessary.

As always, please don’t hesitate to call our offices if we can be of service in any way.

- 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.