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A Special Report October 9th, 2009 A “Show Me” Market

What a difference a quarter makes! As I write this, we’ve just completed the best quarter for domestic equity returns in eleven years, and its completion closely coincided with the one-year anniversary of the most dramatic market sell-off in my career, a sell-off ignited by the Lehman Bros. collapse on September 15th 2008. It’s an anniversary we don’t exactly “celebrate” around here, but rather somberly observe, much like the anniversary of “Black Monday” (10/19/87), the Kennedy Assassination (11/22/63), and the day the Red Sox’ Bill Buckner let that ball bounce through his legs in Game 6 of the ‘86 World Series against the Mets, effectively killing the Sox’ hopes for a title...again (10/25/86).

The quarter ending September 30th was the second consecutive positive quarter for stocks, those following six consecutive bloody quarters where investors found shelter almost impossible to come by. We’re still far from the lofty heights reached in October 2007, but the gains are welcome nonetheless. Here’s the quarterly, and year-to-date 2009 results for stocks and bonds:

	Returns* <u>Qtr. End 09/30/09</u>	Returns* <u>Year-to-Date 09/30/09</u>
Dow Jones Industrial Average	+14.97%	+10.66%
Standard & Poor’s 500 Index	+14.98%	+17.02%
NASDAQ Composite Index	+15.64%	+34.58%
Russell 2000 Index	+18.89%	+20.99%
MSCI E.A.F.E. Index (Foreign Stocks)	+18.80%	+25.49%
Barclays Aggregate Bond Index	+ 3.70%	+ 5.72%
Barclays Corporate High Yield Bond Index	+14.20%	+48.98%

* Equity index returns exclude dividends

The gains we've seen this year are certainly welcome, but one must keep them in context. While the year-to-date gains are impressive on their face (up 58.2% from the March 9th lows), a longer-term perspective reminds us that we remain (-29.2%) below the 10/09/07 all-time stock market peak.



Source: Russell Investment Group, Standard & Poors, FactSet, J.P. Morgan Asset Management

The two weeks ending Friday, October 2nd, however, delivered *losses* in the equity markets, the first two consecutive weeks of losses in months, a sign that the recovery may be showing signs of running out of steam. Now we head into the quarterly earnings season that began with Alcoa's report Tuesday evening, and notwithstanding the past couple days' bump in prices, market participants appear to be adopting a "show me" attitude before further (meaningful) gains are likely. Investors want to see earnings improvements fueled by top-line sales and volume growth, instead of cost cutting alone.

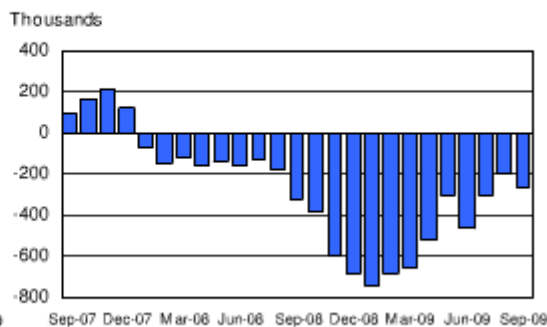
Top line sales growth and increased consumer demand for products and services will be hard to come by in the current economic environment however, as the headwinds from this "mother-of-all-recessions" continue to blow. Challenges to recovery (and continued market advances) include:

- **Persistent (and rising) unemployment.**

Chart 1. Unemployment rate, seasonally adjusted, September 2007 – September 2009



Chart 2. Nonfarm payroll employment over-the-month change, seasonally adjusted, September 2007 – September 2009

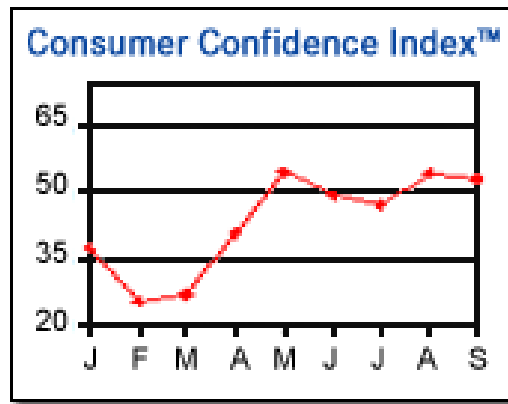


Source: <http://www.bls.gov/news.release/pdf/empst.pdf>

As you've no doubt heard by this point, the Bureau of Labor Statistic's September unemployment report delivered a higher than expected 263,000 job losses, bringing cumulative job losses since the recession's start in December 2007 to 7.6 million. (The unemployment rate in metropolitan Detroit is 17.0%!) A total of 15.1 million Americans are collecting unemployment benefits today, bringing the "official" unemployment rate to 9.8%, the highest in 26 years. It's expected to breach 10% before the job losses subside.

That's *in addition to 2.2 million* Americans who've exhausted their unemployment benefits, and are no longer (officially) counted in the rate. And there are *another 9.2 million* part-time employees (commonly referred to as "under-employed") who'd prefer full-time or higher paying work if they could find it. That's a grand total of 26 million potential wage-earners who won't be spending at malls, auto dealers, or upscale restaurants anytime soon.

- **Consumer's Confidence Remains Low**



Source: <http://www.conference-board.org/economics/ConsumerConfidence.cfm>

Not surprisingly (to me) given the massive job losses, the Conference Board's Consumer Confidence Index fell in September to 53.1, down from its August reading of 54.5 in August (1985 = 100). While an improvement from its all-time low reading of 25 in February, it's a far cry from a healthy number, and until or unless consumer confidence improves, consumer spending, which accounts for 70% of economic activity in this country, will continue to be depressed, further impeding the economy's attempts at a recovery.

- **Businesses Aren't Spending Either**

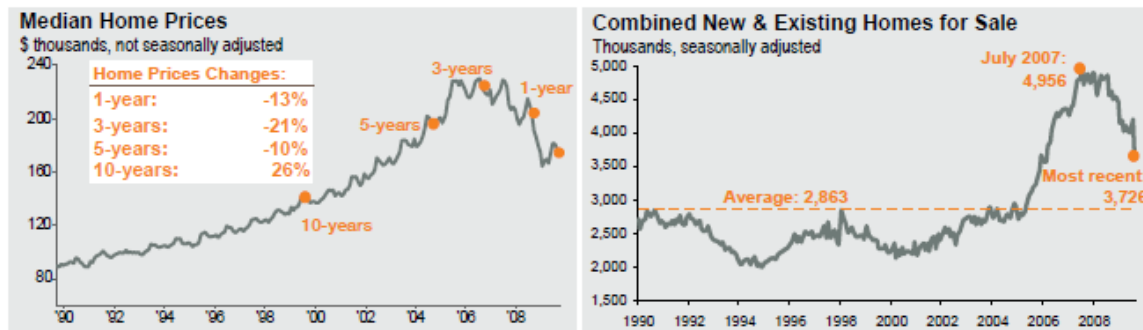
The Commerce Department reported Friday that Manufacturers' orders, shipments, unfilled orders, and inventories were *all down* in the month of August. Unfilled orders for manufactured goods have been down for eleven consecutive months, the longest streak in history. Manufacturers simply don't see the demand for goods necessary to spend robustly on infrastructure and capital improvements. Industrial Capacity Utilization remains very weak, currently at 69.6% nationally, a full 11.3% below its average for the years 1972 – 2008, according to the Federal Reserve's latest figures (09/16/09).

- **Credit Remains Extremely Tight**

Despite hundreds of billions of dollars of stimulus money spent on toxic assets, intended to provide relief to banks' balance sheets, and to provide them liquidity with which to lend, business credit remains incredibly tight. Stung by residential and commercial mortgage defaults, banks all but stopped lending to the business community earlier this year, and are reluctant to restart before they see improvement in the economic cycle, a "Catch-22" of sorts.

Small business owners with excellent credit and who have never been late on a payment are having their credit facilities pulled, and small business is the engine for job growth. Even larger businesses are finding it difficult to find needed credit. The Federal Reserve Senior Loan Officer Opinion Survey reported this spring that 83.2% of them had "tightened" their loan standards for medium to large businesses. Without available credit to creditworthy borrowers, especially in industries like retail and construction, the economy will simply not expand as it is capable.

- **Housing, While Appearing to Have Stabilized, Has Another "Wave" Coming**



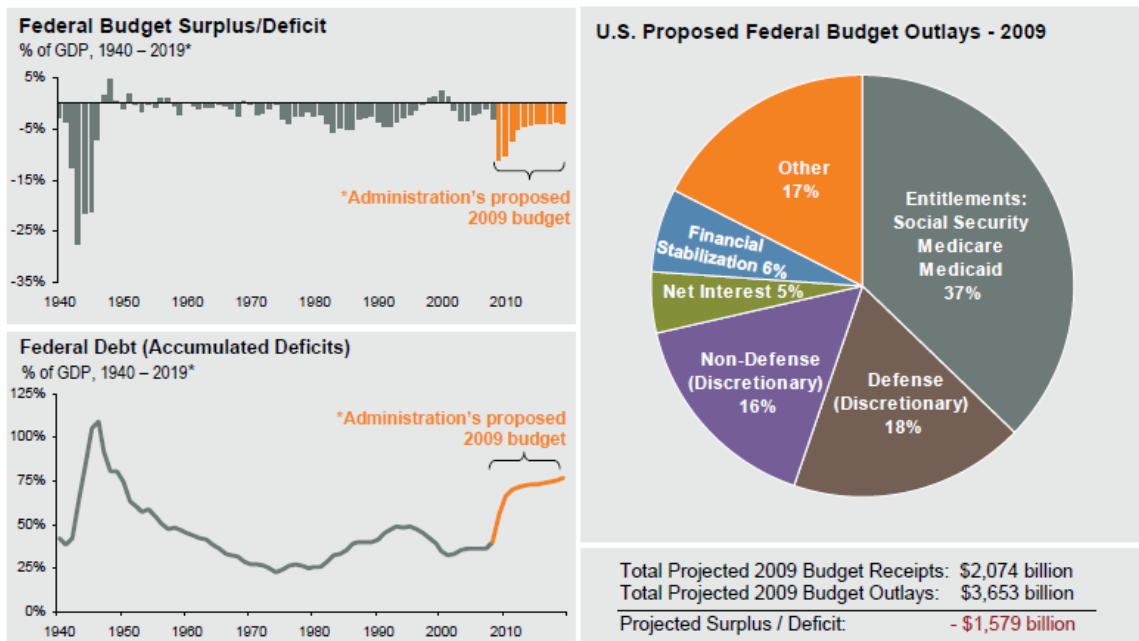
Source: Census Bureau, FactSet, EcoWin, J.P. Morgan Asset Management, National Association of Realtors

Housing prices nationally are back to 2003 levels, having "bubbled" in the 2005 – 2006 time frames. The S&P/Case-Shiller 20 City Index of national home prices peaked at an Index level of 206.52 in July 2006, and fell (-32.57%) to 139.25 in April 2009. Not surprising to many of the readers of this report, all real estate is "local", with many of these cities seeing far greater "peak-to-trough" declines in home prices. Phoenix, for example, has fallen (-54.46%) during the same period. While the 20 City Index has stabilized somewhat since April (144.23 as of July, the most recent number available), there are some really ominous data in the report. According to the survey, *delinquencies continue to rise*. A full 9.24% of all mortgage loans are delinquent today, and while existing ("for sale") single-family home inventories have declined in recent months to an 8.2 month supply, the "shadow inventory", defined as homes that are in, or are soon to be in the process of foreclosure, is projected to be an incredible additional 7 million homes!!! Mortgage lenders simply cannot "eat" 7 million homes, and the market isn't there to efficiently absorb them. Insiders are worried about further sharp declines in home prices as a result.

- **Government Debt is Exploding!**

As the charts below show, the federal deficit for fiscal year 2009 is projected to reach \$1.579 trillion, a deficit larger than the five prior fiscal years...combined!

According to the President’s Office of Management and Budget (OMB), total federal debt outstanding is \$12.867 trillion today (\$8.531 trillion held publicly), but will balloon to \$23.290 trillion by 2019 (\$16.027 trillion held publicly). You may or may not agree with the President’s budgetary and spending priorities, but everyone agrees that servicing that debt will take a larger and larger percentage of the government’s gross revenues, effectively “crowding out” private borrowers (businesses and consumers), which would likely leading to higher borrowing costs and inflation.



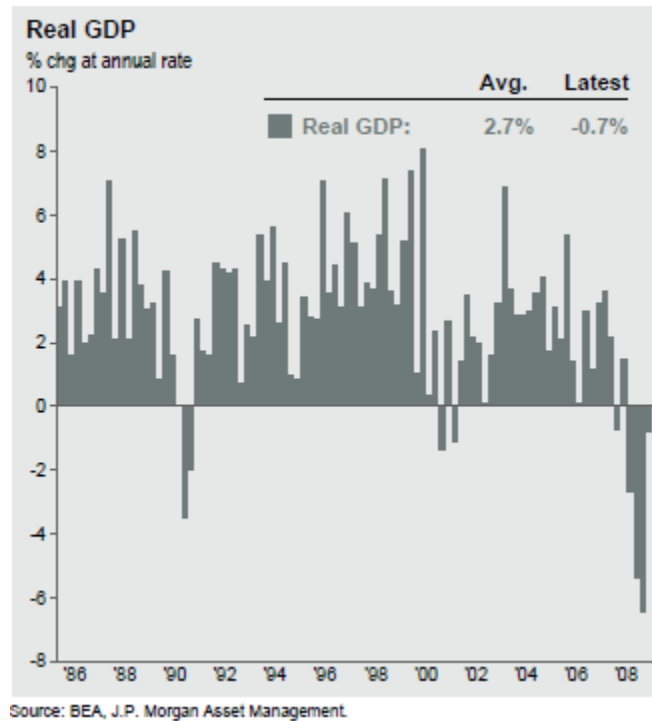
Source: St. Louis Fed, Bureau of Economic Analysis, Office of Management and Budget, J.P. Morgan Asset Management. Data reflects most recently available as of 9/30/09. Source: Office of Management and Budget, J.P. Morgan Asset Management.

Note: Years shown are fiscal years (Oct. 1 through Sep. 30). Bottom left chart displays federal debt in the hands of the public.

High unemployment, low consumer confidence, tight credit, and millions of home foreclosures are not exactly a “recipe” for economic or market growth. But it’s not all bad news, as signs of recovery are apparent to those who look closely enough.

- **Gross Domestic Product (GDP) May No Longer Be Negative**

Our nation’s collective output is expressed as Gross Domestic Product (GDP). GDP represents the “size” of the economy. Having peaked at \$14.54 trillion in the quarter ending September 2008, it has declined the past three calendar quarters by (annualized) percentages (-5.4%), (-6.4%), and (-0.7%) respectively, to \$14.15 trillion. As the chart below illustrates, these declines have been (by far) the largest (worst) in a couple decades. Economists project the data for the quarter just ended will turn positive, perhaps to an annualized rate as high as 2.5% - 3%, signaling an “official” end to the recession.

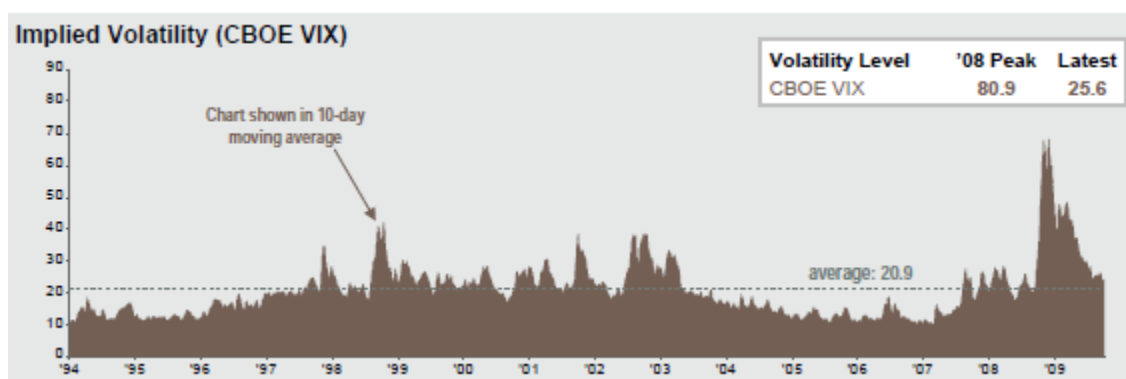


- **Historical Recoveries**

According to Standard & Poor’s, equity market recoveries that followed the nine previous post-World War II “Bear Market” declines (declines greater than 20%) have averaged 176.0%, and lasted an average of 68 months. The 58.2% recovery we’ve enjoyed thus far has taken only 7 months, implying further gains may still be available.

Of course, the average decline during those nine bear markets was only (-32.6%), as opposed to the much larger than average (-58.8%) peak-to-trough decline we just experienced, strongly suggesting this was far from an “average” bear market. During the prior recoveries, it took, on average, 2.2 years for equity prices to return to the prior peak, and in order for this one to match that average, we’d need to see the S&P 500 Index get back to its closing high (1565) by mid-spring, 2011, again, a 29% gain from current levels.

- **Market Volatility, While Still Higher Than “Normal”, Is Getting Better**



Source: J.P. Morgan Asset Management, Merrill Lynch, CBOE, EcoWin, FactSet

While market volatility is still (approx.) 22% higher than the average of the past fifteen years, it was as much as 300% higher than average in October – November 2008. With volatility returning to (relatively) normal levels, investors should become more and more comfortable committing resources to the markets.

- **The “Technicals” are Compelling**

Time honored “fundamental” measurements of market levels (i.e. stock prices relative to earnings, sales, etc.) are troubling, as stocks are no longer considered “cheap” by these traditional formulae, but technicians (i.e. chartists, trend followers, etc.) are actually finding the markets more and more attractive as prices move higher. Resistance level after resistance level have been breached in this run-up in prices, and we are approaching some key technical levels on equity indices, which, if breached, leave a lot of open space to the upside before serious resistance is reached.

Never having been a technician in the past, the fundamentals have always been my focus, and the concepts behind momentum trading, and “buying high, and selling higher” have always seemed counter-intuitive to me. But there are a substantial (and growing) number of individual and institutional investors (including many of our new money managers) who use charts to identify and exploit trends and trend reversals, and their influence on the market can no longer be discounted. The “trend” (pun fully intended) among investors toward technical chart following is building momentum, and technicians are no longer considered a “lunatic fringe” element within the markets. They are accelerating their buying of equities as the market rises, and the recent market gains have pushed short-term moving averages, which are key indicators that would ultimately signal a trend reversal (i.e. a “sell signal”) far above those trigger points. What that means (in English) is that prices in many markets would have to fall substantially from current levels before the technicians will run to the sidelines.

- **We're Still Awash in Cash**

According to the Investment Company Institute (ICI), as of September 30th, Money Market Mutual Funds held \$3.338 trillion in cash, down \$430 billion from its record level of \$3.849 trillion, reached in January of this year.

Many prognosticators believe that this cash, essentially earning zero percent interest, will sooner or later find its way into the stock markets, as investors, many of whom sold in panic in 2008, become convinced that the equity market rally is for real. They suggest that this much cash on the sidelines will provide additional demand for stocks, causing market dips to be briefer and shallower than would be the case if the dollars were already sloshing around the equity markets.

The counterargument is that some of these investors were permanently scared off, and will never return, and that not all of these dollars will find their way back into the equity markets. Some of these funds will be used to invest in bonds, real estate, gold, or other asset classes besides stocks, and I concur.

However, some of it, perhaps a large percentage of it *will* in fact, find its way back into the equity markets, and if it does, it can only help support prices.

As you can see, as usual, market signals are mixed, with solid arguments *for*, and *against* further advances in equity markets. All we know is that nobody knows which direction the next 10% move in the markets will follow. That is all the more reason to manage assets in this type of market environment with both “buy”, *and* “sell” disciplines. Our managers have clearly articulated strategies to implement *both sets of disciplines* as they navigate these still treacherous market tides, and that is why yours truly is sleeping better through all this tumult.

Participating as our clients have in this year's market advance has been extremely enjoyable, and no doubt financially rewarding, especially after the declines of 2008, but having some downside protection (i.e. a *defense*) against a possible market pull back is a welcome additional insurance policy against a repeat of last year's nightmare.

Maybe I'll even get to spend some time watching the baseball playoffs that began this week. If only the '86 Sox had had a better defense.....

-JRP

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