

# What Now?

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The third quarter of 2009 is in the books and what a quarter it was for the equity markets. With great returns in the last quarter and year-to-date returns now positive on the major indices, the question becomes: What Now?

To answer that, let's take a look at how the markets got to this point. We started 2009 where 2008 left off and that was in a severe bear market. This all began to change around mid March, and the markets have been trading up ever since. The question is why? Did the economy change that drastically? Have the fundamentals improved that much? The answer of course is no. The reason behind the soaring market can be summed up in one word: stimulus. Stimulus provided by the U.S. Treasury and the Federal Reserve. The bulk of the stimulus dollars hit the system beginning in March, the same time the markets began to rally. If we look a little closer we see that the sectors that had the best performance since March are the sectors that received the direct stimulus dollars. Housing (\$8000 for new home buyers), autos (cash for clunkers), banking (\$1.25 trillion in purchase of mortgage back securities by the Federal Reserve AND \$300 billion of direct purchases of Treasury securities by the Fed) all have performed better than the rest of the market. *The stimulus packages are definitely helping the stock market, but as the programs come to an end the same markets will come under pressure.*

There is no question the markets have been great but we need to keep it in perspective. While the S&P 500 is up over 50% from the low point in March, the returns are being driven by some very unlikely companies. Take AIG for example. AIG was at the epicenter of the entire financial crisis, along with Lehman (out of business) and Bear Stearns (out of business). AIG was, for all intents and purposes, bankrupt a few months ago. Thanks to a government bailout and some stimulus dollars to their trading partners, AIG's stock price is trading up 516% from the low earlier this year. That is not a typo.

Other stimulus beneficiaries are doing just as well. From their low points earlier this year, Bank of America is up 440%, Wells Fargo up 270%, Ford Motor up 400%, General Growth Partners up (from bankruptcy) over 1400%.

The point is that the general markets are doing well, but not as well as the return numbers are showing. *The returns are being generated by the riskiest companies, companies that wouldn't be a part of a stable portfolio.* The stable companies like Kellogg or Coca Cola are up 8-10% on the year. Companies like Wal Mart and Kraft are actually down on the year.

With this in mind, let's get back to the question of "What Now"?

If we take a look at the overall economy, the recent market movements and what has happened in the past during similar scenarios we can see a pattern emerging. When the markets have moved up sharply in a short period of time it is generally followed by extended periods of

sideways movement. We will see normal fluctuations but the over the longer term the markets generally show no real appreciation. During these times it is important to concentrate on income producing assets. Most insiders this year were selling their companies' stock. Most big money was moving into 3 to 5 year bonds and at this time it is very difficult to get decent quality bonds of that duration. The stage is probably set to drift in a zone for a good period of time, particularly given interest rates probably won't increase for another 6 to 12 months at least.

In the chart below we can see two similar instances. In the late 1930's and in the late 1970's the market experienced a sharp downturn followed by a sharp upturn of very short duration. Each time the market moved up over 50% in 6 months or less. Each time, this situation was followed by an extended period of the market moving sideways.

