

Quarterly Review and Outlook – Second Quarter 2009

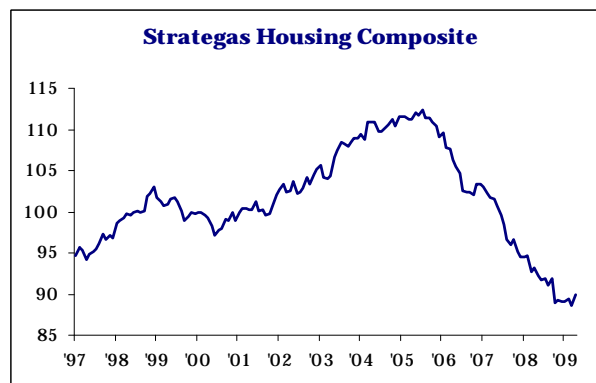
How quickly things change. In the first quarter of 2009 equities were down 9-15% depending on the benchmark. That dismal performance included a significant rebound of 20% from March lows. Fortunately the rally continued into the second quarter and resulted in positive returns for the quarter. Domestic equity markets were up 16-21% during the quarter putting the S&P 500 up 3% for the year with mid caps the best performer up 10% for the year. International markets also enjoyed a strong quarter up 25% with emerging markets up 35%. For the year developed international markets are up 8% and emerging markets are the strongest performer up 36%. Bonds posted positive results for the quarter and are up 2% for the year as measured by the Barclays Aggregate bond index.

Time for the all clear?

We wish that we could be as enthusiastic about the economy and markets as the most recent quarter’s equity performance, but our view is that a cautious strategy continues to be the best option for your portfolio. We often talk about taking only appropriate risk in the portfolio and the current environment suggests to us that numerous risks remain for the markets.

In recent outlooks we have been discussing the importance of housing to a sustainable economic recovery. We believe that housing was the tide that went out exposing an overlevered global and US economy. We continue to believe that the economy will continue to experience a drag until the fundamentals of housing stabilize and improve. In our view that recovery remains elusive as we still see significant risk as foreclosures continue at a rapid pace, supply continues to put pressure on pricing, financing is challenged, and mortgage resets remain on the horizon.

The following chart is from Strategas which we updated from last quarter. This chart is a composite of monthly data that is provided on housing starts, new permits, new home sales, existing sales, home inventory, affordability, home prices, residential construction, purchase applications and buying surveys. As you can see, the data suggest that housing is still far from recovered. We have stabilized at a low level, but no meaningful recovery has begun. We are hopeful that the stabilization continues but significant headwinds remain.



We believe our focus on the importance of housing to sustainable recovery is appropriate, but we are not alone. Mohamed El-Erian, CEO and Co-CIO of Pimco, one of the largest fixed income managers in the world, said recently, “We should worry most about housing...Housing is still central to the stabilization and eventual recovery of the U.S. and global economies. Any further decline in house prices will erode the collateral many Americans borrowed against, dampen their already-fragile consumption appetite, and increase the headwinds facing a banking system that is finally regaining its footing.”

As if that is all we worry about

The ongoing correction in housing is an extremely important aspect of this current cycle that needs resolution, but other issues are providing challenges to recovery. The two most significant are unemployment and the unwinding of excessive leverage. Our economy has suffered 6.5 million job losses since this recession began. The unemployment rate stands at 9.5% heading its way towards double digits. Many people have dismissed negative employment figures because it has historically been a lagging indicator meaning unemployment continues to get worse after the economy starts recovering. We have been wondering aloud whether this lagging indicator can become a leading indicator in a deleveraging economy with asset prices falling. We are pleased to see several well-respected economists have recently warned of the potential of a negative feedback loop. Rising unemployment causes more mortgage defaults which causes house price declines which results in declining spending which forces companies and governments to cut back which causes unemployment to rise. It is not too difficult to imagine how this could spiral out of control.

The other issue relates to deleveraging. While housing was the source of the problem, it was fed by excessive leverage (debt). This leverage manifests itself in bulging household and corporate (including financials) balance sheets. With asset prices declining excessive leverage becomes dangerous. As consumers and businesses rebuild their balance sheets, leverage will be reduced but so will economic activity and the earnings power of companies. The deleveraging that is occurring is part of the healing process but will likely hinder growth going forward. This is making policy makers jobs all the more difficult.

We believe a continued cautious investment stance is warranted but we do acknowledge that significant actions have been taken by the last two administrations and the Federal Reserve to foster a recovery. The Federal Reserve has been doing the heavy lifting in terms of substantive policy actions to support the markets and the economy. We believe the actions by the Fed, while undesirable and undoubtedly with unintended consequences, are essential for getting the economy moving. We remain convinced that we will see recovery and a return to normalized economic activity. In that environment, stocks should reflect their underlying earnings power and good companies with strong prospects and fundamentals will be rewarded. Right now the question remains when will that occur.

V, U, or L

A rebound in the market depends on a sustainable trend in economic activity. Market commentators and economists often liken economic cycles to letters of the alphabet. The debate rages on which letter this current cycle will take. In consideration of the unbelievable amount of stimulus that has been pumped into the system, many have suggested that we will experience a strong V shaped recovery once it begins in earnest. The market's rebound makes us wonder if it does not believe a V is the most likely course. We are unfortunately not as optimistic in the short term as a U, L or W seem more likely to us but nothing is certain or clear. We have talked about the numerous structural headwinds that we face as an economy and we are experiencing something far from typical when compared to a normal recession. For this reason we continue to anticipate bumps in the road and unforeseen difficulties.

Inflation

Whatever the eventual shape of the recovery, our biggest challenges may come in dealing with many of the unintended consequences of unprecedented stimulus being thrown at our economy. One of the likely consequences of the enormous amount of monetary and fiscal stimulus is that too much money in the system chasing the same goods can create inflation. Our policymakers have been diligent fighting the debasing forces of inflation since Paul Volcker took over the Federal Reserve in 1979. Many fear that the



extraordinary amount of stimulus will be too much for policymakers and inflation is the likely result. While this is a risk, we do not

share the same heightened level of immediate concern for a couple reasons. First, a return of inflationary pressure would signal that the economy is getting stronger. From where we sit today we would gladly accept a little inflation in exchange for economic growth. Second, there is a large amount of slack in the economy. With economic output and the employment picture so weak, inflationary pressure can only occur as this slack is used up, driving prices and wages higher. This could take some time, but logic dictates that it is entirely possible.

We are often asked how we protect portfolios against inflation. There are two primary ways in which we are protecting the portfolio from inflation. First is in fixed income portfolios. We believe that in general interest rates over the longer term will follow the rate of inflation. If inflation were to rise, then interest rates would likely rise. Currently, we are maintaining durations (duration is a measure of the sensitivity of bond prices to changes in interest rates) that are shorter than average. This means that if inflation were to drive rates higher the value of portfolios would be less sensitive to those changes and would preserve capital more effectively.

Second, in equity portfolios, because we do not view inflation as an immediate concern, we have not made any strategic allocations to inflation sensitive sectors such as commodities. That being said, equity portfolios do have significant exposure to such areas. Our calculations based on March 31 data suggest that equity portfolios have 20% allocated to inflation sensitive sectors such as energy, basic materials or commodities. We believe that in the current environment this exposure is adequate, but will make changes as we see opportunities or needs. Our current view is that over the near term deflation remains the greater risk compared to inflation.

Resist the inertia of negativity

A while back we suggested that to invest successfully one must resist the inertia of negativity. This is no more true today than it was in the fourth quarter of 2008. There are indeed structural headwinds and sources of imbalances that make the likelihood of a rapid recovery uncertain. We are confident that a recovery will come, consequences will be dealt with appropriately, and the global and US economies will return to attractive growth. What keeps us cautious is the timing and we are happy to wait defensively until we see more encouraging signs besides a few “green shoots”.

We are also excited by the opportunities within the asset classes in which we invest. We believe that equities, while currently much closer to fair value than early March, remain a very attractive way to generate returns. Strategies and managers that have proven their ability to generate returns as well as manage risk will continue to be our focus. We also continue to view fixed income as a good diversifying asset for portfolios. Beyond that bonds offer an attractive risk – adjusted return profile that will continue to benefit portfolios. As always our goal is to position the portfolio to achieve your objectives while taking an appropriate amount of risk.

As you review this report and consider our outlook, please do not hesitate to call us at any time with your concerns or questions. We thank you for your trust and confidence as we guide you through this challenging period for the markets and the economy.

Best regards,

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