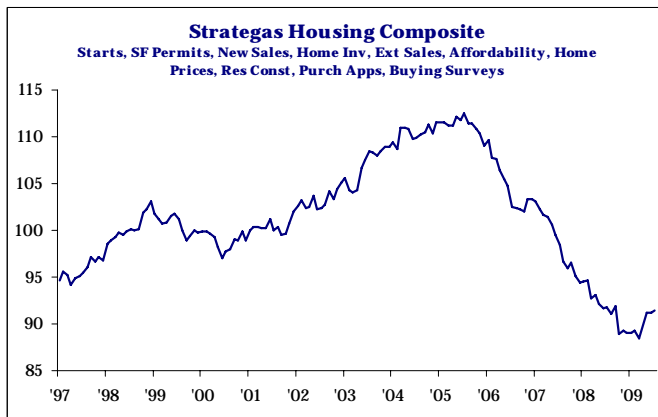


Quarterly Review and Outlook – Third Quarter 2009

The equity and bond markets both continued to enjoy significant positive momentum during the quarter. Equity indices continued their parabolic rise since making a low on March 9th of this year. Year to date, international markets (EAFE up 29%) have outperformed the US (S&P +19%). Bonds have performed well with the Barclays Aggregate up 6% for the year. Spreads on bonds have tightened dramatically and have contributed largely to the robust returns in that market as Treasuries are largely flat. Returns from high yield bonds have outpaced most equity indices.

It would be hard to deny that the economy has improved since the beginning of the year. It seems every economic data series or indicator has gotten better (or less worse as the case may be). The mounting evidence that we were not going to experience the next Great Depression was reason enough to cheer a sign of relief and bid stocks and bonds up. We are pleased that we are seeing very positive signs of recovery but it appears to be somewhat artificial. Areas that have benefitted the most are those that have been propped up by government stimulus. “Cash for Clunkers” is a perfect example as car sales skyrocketed under the program only to fall the next month after the program ended. We question whether the economy can stand on its own without the heavy hand of government holding it up.

As the global economy continues to show promising signs of recovery, there remains plenty to worry about. The structural resilience of the global economy after an unprecedented credit collapse has been our focus over the last 18 months. We still worry about housing and the strength of recovery. We are now seeing the first real signs that housing prices have stabilized which are a necessary ingredient for us to believe in a sustainable economic recovery. Having said that, we are not convinced that the housing recovery can be sustained due to the likelihood of high supply in the housing stock continuing to far outstrip demand. This will likely be a source of continued pricing pressure as we move into 2010. We have provided the Strategas Housing Composite in previous outlooks and want to include it again for comparison. From this graph you can see that housing data has improved somewhat, but it remains well below trend.



In addition to housing, the global economy faces significant headwinds that must be dealt with before a lasting recovery can take hold. These headwinds represent new dynamics that will predominate the landscape for the coming years. Our responsibility is to understand and plan for those challenges to effectively manage the risk/reward dynamic in the portfolio.

PIMCO’s New Normal

PIMCO, the largest bond manager in the world, recently termed this new landscape as “The New Normal”. The New Normal is a world where the financial system will be de-levered, de-globalized, and re-regulated. These dynamics will affect individuals and companies alike as access to credit is rationed, competitive forces are altered, and the government plays a larger role in what has been historically left to the private sector. PIMCO believes that the results will be slower economic growth, higher unemployment, more muted profits, more capital destruction due to defaults, abrogation of property rights, and continued dollar devaluation.



Most economists and other market commentators have taken a similar position in forecasting a multi-year period where global growth is positive but below potential. We tend to agree that deleveraging will likely have a muting effect on economic activity for the foreseeable future. In effect, this is the most likely and logical environment for the next 3-5 years. But that isn't what worries us. Under this scenario of positive but modest growth, we can move forward and portfolios that are properly allocated could generate acceptable returns.

What about “Fat Tails”?

Understanding the consensus is important but also important is understanding what can happen if the consensus is wrong. In essence, we worry about the “fat tails”. Fat tails refers to the outlier events in a probability distribution that is non-normal. These events, like a financial crisis, are hard to predict because their occurrence is rare, but when they do occur they have a significant impact. For example the 2008 credit crisis is one such event. The current consensus regarding the outlook for the economy is the most likely outcome, but achieving success in predicting the actual results of a complex global economy has historically proven difficult.

Therefore, we must be prepared for what happens when we deviate from that consensus. There are two primary scenarios to consider. First, the economy recovers much more quickly than the consensus view and we have stronger than expected growth. This is what we believe the equity markets are discounting. The second scenario is that our tenuous recovery falters and we fall back into a recession. While we believe the consensus view is the most likely (and the bond market seems to agree), we keep our eyes on these potential scenarios or “tails”. The former is obviously preferable to the latter but in managing portfolios we want to ensure that any outcome would not result in challenges to the portfolio that cannot be overcome.

Since the lows of March, the equity markets are up across the board. The S&P 500 has rebounded more than 60% but still remains well below its high of 1,560 in October 2007. Bonds have rallied as well. High yield bonds are up more than stocks and high quality corporate bonds are up mid-teens. We do not expect a repeat performance out of stocks or bonds in the next six months. Therefore, we must focus on the fundamentals and believe that bonds and alternative strategies currently have a superior risk/reward trade-off compared to stocks. While we do not find stocks overly expensive, the valuations do not provide much room for downside protection if a more challenging economic environment presents itself.

To us the best course of action remains unchanged. We want to maintain a cautiously optimistic stance in the portfolio that will allow us to participate in the recovery we are experiencing. If the consensus view is wrong and it turns out better than expected we may miss some upside, but if we have another market correction the portfolio will be protected. In this environment, we believe it is in your best interest to err on the side of caution.

As always, if you have any questions regarding your report or this outlook, please do not hesitate to call us. It is a pleasure working with you. Thank you.

Best regards,
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