Investment Commentary
April 1, 2009

Last week I attended the annual Wealth Management Conference hosted by the Chicago Society of the CFA Institute. I have attended this conference every year for the past several years and couldn't help but notice that attendance appeared to be less than half of previous years. This economy has been unkind to many industries. It has been brutal to the investment industry.

One speaker, an economist, shared his views on our current economy noting that, at fifteen months, this recession will soon be the longest recession in post-war (WW II) history. Gross Domestic Product for 2009 is forecast to shrink 3.2%, making it the most severe recession as well. From 1952-1998, households in the United States enjoyed a "financial surplus". This means their financial assets exceeded their financial liabilities. Since 1999, households have been running financial deficits. Years of easy access to money, using home equity as collateral, finally took its toll. He said the last domino to fall in a recession is commercial real estate.

Even though that domino has yet to fall, he ended his talk with a surprising note of optimism. He feels the U.S. will emerge from the recession in the 4th quarter of this year. He based this on his belief that there will be a fundamental change in consumer spending. The consumer spending to which he refers is "foreign" consumer spending. In other words, we will benefit from other nations spending their money on our goods and services. As the rest of the world is growing and getting wealthier they will begin to demand more of the items we produce:

- Agricultural products and technology (e.g. tractors & fertilizer)
- Food
- Health care (e.g. X-ray & MRI machines)
- Infrastructure

His optimism was tempered by a subsequent speaker who focused his view of our economy on the corporate credit markets. He pointed out that in June, 2007, High Yield bonds (the riskiest bonds) were trading at an interest rate just 2.6% higher than U.S. Treasury Bonds (the safest bonds). This means investors were willing to take a lot of excess risk for not very much extra return. In December, 2008, High-Yield bonds were trading more than 20% higher than U.S. Treasury bonds. This means investors were demanding very high rates of return in exchange for taking excess risk.

Clearly the corporate debt market is expecting severe problems. This speaker is expecting corporate defaults to increase and that the recession will last well into 2010, possibly 2011.

At Boyer & Corporon Wealth Management, we lean toward the expectations of the second speaker for all the reasons he listed as well as several additional reasons including:

- The commercial real estate problems are still in front of us, not behind us.
- Home prices fell in the 4th quarter of 2008 by almost 20% from the 4th quarter of 2007.
- Home prices are now down over 30% since mid 2006.
- In February, there were 272,000 new foreclosures. That is approximately 9,000 new foreclosures every day.
- Unemployment continues to grow and over 6 states already have jobless rates exceeding 10%.

That last bullet point is the one that is beginning to concern us most. Although unemployment is officially 8.5% nationally, that number is not representative of the true state of unemployment in this country. It does not include employees who are working a shorter work week in order to keep their jobs. It does not include employees who have taken a cut in pay in order to keep their jobs. And it does not include those who have given up seeking employment. The "effective" unemployment rate in this country is estimated to be as high as 15%.

On March 19, the Federal Reserve announced it will buy back $300 billion of long-term Treasury Bonds. This is in addition to President Obama's stimulus plan. The Fed cannot stimulate our economy by cutting interest rates because interest rates are already as low as they can go. And yet the economy is still listless. So the Fed has to attempt other actions to stimulate our economy. Purchasing Treasury securities adds money to our economy which the Fed hopes will increase economic activity. This announcement had the effect of making interest rates decline on long-term securities. Lower interest rates cause the dollar to decline in value (relative to other currencies) because investors sell the dollar and purchase currencies in which they can earn a higher rate of return. A cheaper dollar makes our products cheaper to foreign consumers which would ultimately be a positive for economic activity.

On March 20th, the interest rate on a 30-year mortgage fell below 5%. The ironic unintended consequence of this is that homeowners with good credit are now able to re-finance their homes with a lower interest rate. We are not sure what this does to sub-prime borrowers.

In the month of March there hasn't been very much in the way of economic bad news. The result has been that since March 9th, there has been another stock market rally similar to the one from November 20th to January 6th. During that November to January period, the stock markets

rallied approximately 20%, a rally that was eliminated in the next month (and then some). From March 9th, the stock market has rallied approximately 16%. We are not impressed with this rally either and have viewed the increase as an opportunity to take more money out of equities.

The other reason we can tell there hasn't been very much bad news is that the primary headline almost every day for a month has been about the bonuses handed out at AIG. Without commenting on whether the bonuses are a good thing or a bad thing, I can tell you it is a whole lot of noise about nothing. It is a political windfall in that members of Congress get to be on TV to tell you how outrageous this is and how they are going to do something about it to make it right because "it's tax payer's money". The amount of bonus money paid to AIG employees is less than 1/10 of 1% of the bailout money given to AIG. I'm not saying the bonuses should have been paid….I'm saying Congress could be making a better use of their time…..and our money.

We feel that our country could be at a financial crossroads and that we are gambling a lot of our resources on various financial stimulus packages (whether from the Treasury, the Fed or President Obama). While hoping that they succeed, we have to be cognizant of the reality that they might NOT succeed…..that unemployment will continue to rise, that output will continue to decline and that we may find ourselves in a long protracted "depression". It is in just such an economic environment that a country can find itself most susceptible to social and cultural change. History has shown that when fewer and fewer citizens are the beneficiaries of the wealth of a country, the likelihood of civil unrest increases. And some sort of social and/or cultural change is almost inevitable.

We feel we still live in the best country in the world and hope our leaders today are capable of guiding us away from unproductive changes. I just finished reading "The Subprime Solution" by Robert J. Shiller. The following quote from his book is noteworthy:

> *I emphasize that the possible <u>systemic effects</u> are much more important than the loss of home values in a potential collapse of the real estate market. For however much home values may drop, they will still remain the same homes, offering the same services to all of us. But if the rate of output in the economy falls, that is a real loss, not just a paper one. The balance sheet problems into which people fall if their homes lose value are purely financial losses. But they can be converted into substantial <u>real</u> losses to the economy if they are allowed to destroy public confidence.*
>
> *In a financial system seize-up such as the one we are now experiencing, we must, putting aside our political and policy differences, fall back immediately on a more basic social contract – one that dictates that we as a society will protect everyone from*

major misfortune and keep existing problems from spreading further, subject to the dictates of common sense. That social contract is our most valuable protection for we as a society, can never plan for all possible contingencies.

In the 1930's, our country spent many years banding together and helped each other become productive again. There were some other countries that responded to negative economic conditions with much worse social and cultural change. We hope that our country will maintain the focus that made it so great in the first place.

At Boyer & Corporon Wealth Management, we continue to be very suspicious of stock market rallies. In a couple of weeks we will know the foreclosure figures for the month of March. It will be difficult for us to get excited about equity investing until the trend of new foreclosures is down. I have printed this chart from Bloomberg in a previous monthly commentary. This is updated through February, 2009. As you can see, four years ago, new foreclosures were averaging about 50,000 to 70,000 per month (or about 2,000 per day). For the past 6 months the monthly average is between 270,000 and 300,000 (or about 9,000 – 10,000 per day).

Until this trend is a downward one….and until we feel the problems in commercial real estate are behind us, we continue to wait for better opportunities to purchase equities. Safe, short-term fixed income investments dominate our investment portfolios.