

BARNETT & COMPANY

INVESTMENT COUNSEL

Quarterly Review and Outlook

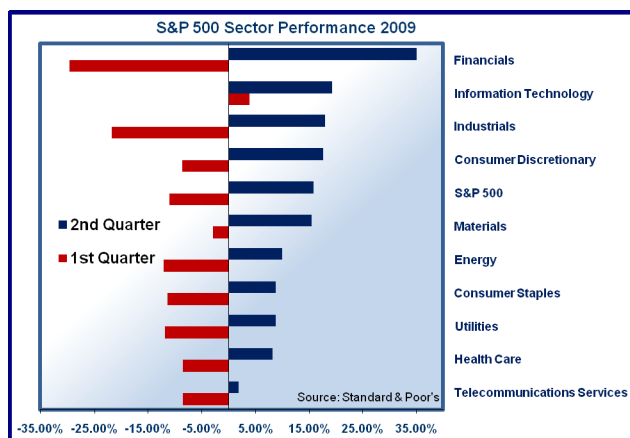
2nd Quarter 2009

Hold Your Horses

After being scratched earlier in the year, global stock and bond markets charged hard out of the gate in the second quarter of 2009. Wagering on an early economic recovery in a parlay on the nascent bull run, buyers crowded the window to place their bets on some of the same nags that stumbled in the previous running of the quarterly sweepstakes. And this time their horses came in. At the wire it was Financial sector stocks going away, with Information Technology and Industrials by a nose over Consumer Discretionary and Materials. In fact every sector in the S&P 500 finished in the money, a sharp reversal from the March derby. The Dow Jones Industrials gained 12.0%, while the S&P 500 climbed 15.9% and the Russell 2000 small-cap index rose 20.7%. The most dramatic move on the backstretch was made by the MSCI EAFE international index, racing ahead 34.7% on hopes of a relatively quick return of super-growth in the Asian economies. In a

dramatic reversal of psychology, investors careened wildly from an abject fear of financial Armageddon to an obsession with chimerical “green shoots” and a determination not to miss the next post. And just as market participants had previously overestimated the likelihood of a catastrophic meltdown, so too have they now laid their bets on an unrealistically optimistic recovery scenario. Economic historian Niall Ferguson describes this excessive bullishness as “wishful non-thinking”. Clearly signs of economic revival are evident, but the pace of recovery will be hobbled by the unprecedented level of Government debt coupled with a historic deleveraging in the private sector. The ponies are back on the track again, but this time with 200 pound jockeys on their backs, just as Uncle Sam threatens to nationalize oat production and mandate universal veterinary care.

Market returns depend ultimately on growth in corporate earnings, which in turn are closely correlated with expansion in GDP. Following a stunning decline in fourth quarter 2008 GDP of -6.3% and a first quarter 2009 drop of -5.5%, expectations are for a further decline of around -2% to -3% in the second quarter before eking out a meager gain in Q3 and Q4. Historically, output tends to expand quite rapidly once the recovery phase of the economic cycle is fully under way, precipitating significant



Quarterly Review and Outlook

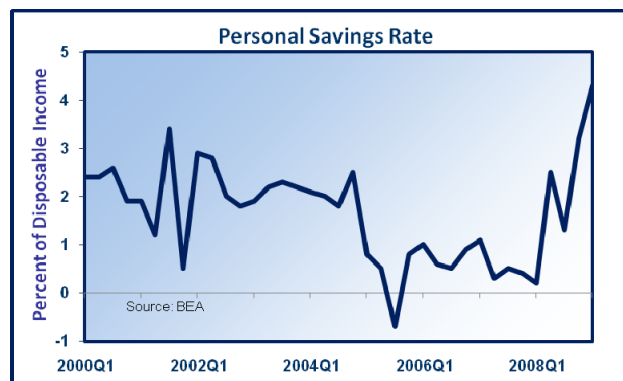
job creation and wage growth and leading to appreciation of financial assets like stocks. The key to understanding GDP growth and why this time may be different lies in the consumer's role in output expansion. Consider the following definition of GDP from the National Income Accounts:

$$GDP = C + I + G + (X - M)$$

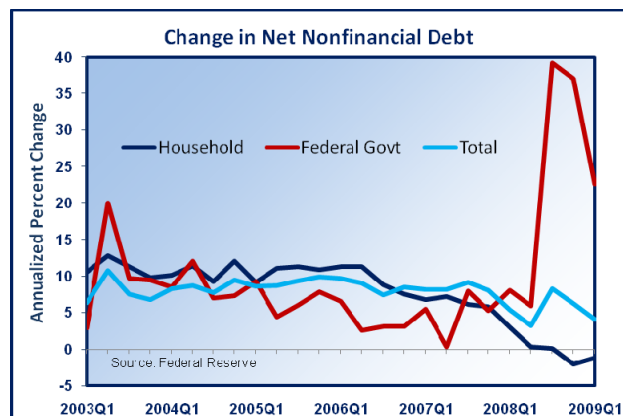
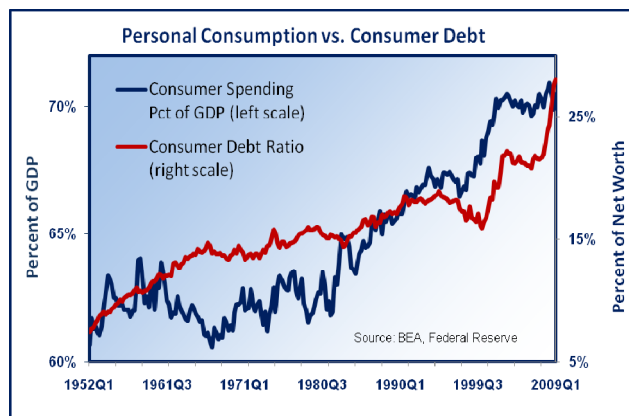
Here total output of goods and services (GDP) is the sum of four factors: consumer spending (C), domestic private investment (I), Government spending (G), and the net deficit of imports over exports (the trade deficit, X-M). By far the greatest factor is consumer spending, which has experienced a relentless upward march from 60% of total GDP in the early 1950s to a (presumed) peak of 70.7% of GDP in the first quarter of 2008. None of the other factors comes close (Government spending accounts for 20%, and private investment 11%). However, this dramatic surge in spending by households has been fueled by an alarming and unsustainable growth in consumer indebtedness as a percentage of total wealth. Prior to the credit crisis households were able to service this increased debt load and maintain their increasingly Lucullan standard of living thanks to a couple of bygone events: the

great bull market for stocks in the 1990s, and the great bull market in real estate in the 2000s. Oops.

Thanks to the bursting of the bubbles in stocks and home prices, consumers now understand that it is prudent to reduce their household indebtedness and thereby ratchet up their personal savings (6.9% of

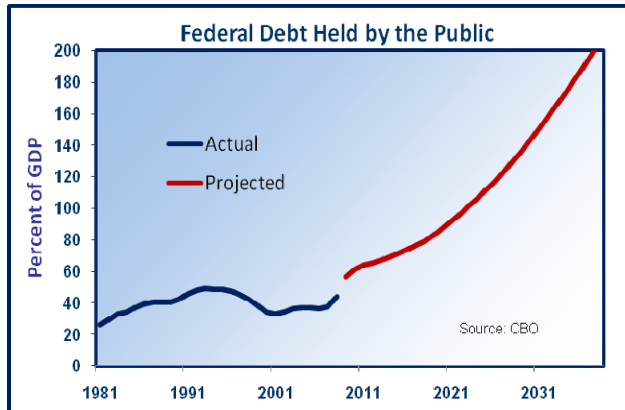


income in May totaling \$769 billion, the highest level since 1992). And thanks to the new rules of the lending game, financial institutions are enforcing this reduction in household borrowing, the result being that consumers will continue to deleverage (like it or not); less borrowing translates into less spending and a reduction in the consumer's contribution to GDP. On the other hand, Government borrowing has grown at a staggering pace compared to the decline in household debt. According to the Congressional Budget Office's most likely



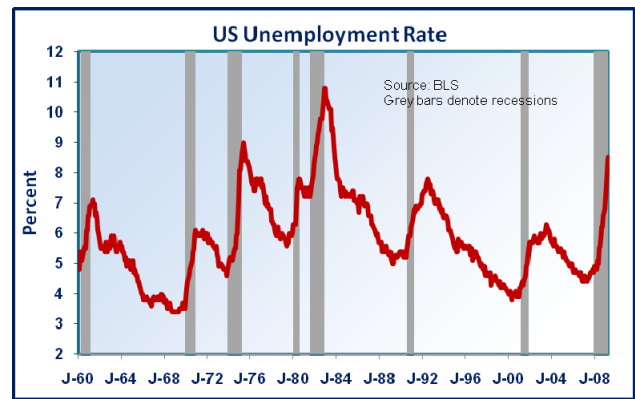
Quarterly Review and Outlook

scenario, US Government debt will double as a percentage of GDP between 2008 and 2019 to 82%, and will surpass the *all-time peak* (immediately following World War II) of 113% by 2026 and crash through 200% in 2038. The inevitable consequences of this



massive borrowing will almost surely include tax increases, interest rate hikes, and crowding-out of private borrowing, growth-killers all. Meanwhile, the immediate stimulative effect from the \$787 billion spending package is likely to be nugatory; the total expenditure is roughly equivalent in size to one month of savings for US households, while most of the actual spending takes place in 2010 and 2011. The shorter-term impact on GDP of this debt-laden Government largesse is highly questionable: the bureaucratic equivalent of borrowing a \$100 bill to light a cigar. So far the economic stimulus package looks like a gelding.

Also weighing on expectations for growth in the intermediate term is the substantial slack in capacity utilization and the attendant surge in unemployment. Since the recession began in December of 2007, 6.5 million jobs have disappeared, driving unemployment to 9.5% and undoubtedly heading north of 10%. Lost jobs never return as quickly as they are eliminated



(note the slope of the unemployment graph during recessions versus recoveries). Furthermore it is unlikely that the pace of job creation will match that of previous recoveries, in part due to structural changes in labor demand (permanent destruction of manufacturing and Wall Street finance jobs, for example), with obvious consequences for sustained GDP growth. Add to these considerations the inevitability of a long, slow resuscitation of the residential real estate market along with an impending crisis in commercial mortgages, and the track certainly appears to be muddy. Forget about the old days of 3.5% average growth in GDP; the new normal will likely be closer to 2%, the implication of which is leaner corporate profit growth and subdued equity returns.

Over the past 30 years investors have been programmed to expect stock prices to rebound quickly following bear markets and are therefore eager to climb back in the saddle. However, considering the leveraging up of the Government and the leveraging down of the consumer, this market recovery may prove to be a horse of a different color.

Christopher A. Hopkins, CFA, CFP
© 2009 Barnett & Company