Quarter Notes

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Stocks Bounce Back

In the 16 weeks since the March 9th low, the S&P 500 index has gained 35.8%. The S&P 500 has had a negative total return in only 7 separate calendar years since 1976. In each of those years when the market was down, the bond market (using the Lehman Aggregate as the benchmark) produced a positive total return. (BTN Research)

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Recession Nearing an End, But Recovery May Be Slow

After two destructive quarters, we were pleased to see a robust rebound in all sectors during the second quarter. The Dow gained 11% and the S&P 500 gained more than 15%. Technology lifted the NASDAQ composite to a 20% gain. The small-stock Russell 2000 also rose by 20.7%.

Index	Close on 6/30/2009	YTD % Change
Dow Ind.	8447.00	-3.80%
S&P 500 Index	919.32	1.80%
Nasdaq Comp.	1835.04	16.40%
Russell 2000	505.28	1.80%
MSCI EAFE	1307.16	5.60%
10Year Treasury	3.52%	

The period of "wealth destruction" appears to be nearing an end. The extreme volatility in the equity markets seems to have calmed. Investors who had the willpower and the stomach to remain with their long-term investment plans have just enjoyed the best investment quarter in more than a decade. Still, portfolios may take some time to return to pre-crash levels.

Household Deleveraging and the Wealth Effect

For years the "wealth effect" fueled the fire of consumer spending. The combination of escalating home valuations, high employment, a rising stock market coupled with low interest rates, and loose lending standards caused household debt to rise to nearly 139% of after-tax income in the fourth quarter of 2008, according to the Federal Reserve Bureau of Economic Analysis.

To say that the recession of 2008-2009 forced changes in consumer behavior would be a gross understatement. When consumers feel poorer, they spend less. In April 2009 US households saved 5.7% of their earnings, the highest rate in the past 14 years. (Business Week 6/29/2009) The deleveraging process resulting from consumers' paying down debt and avoiding new debt will slow economic recovery but is unlikely to derail it completely.

We are starting to see signs of stabilization in the housing market. According to Freddie Mac, which publishes the Conventional Mortgage Price Index, housing prices fell 18.5% in the last quarter of 2008 and fell another 5.3% in the first quarter of 2009. Though final second-quarter numbers are not yet available, it is safe to say that downward price pressure continued, albeit at a slower pace. Foreclosures are still increasing, but the bulk of the new foreclosures are occurring in specific locales such as California, Florida, Arizona, and Nevada.

Government programs included in the stimulus package seem to be working to stabilize home prices and reduce foreclosures in most states. Lower prices, tax credits for new home buyers, looser credit for qualified buyers and continuing low interest rates low are making homes more affordable and giving some homeowners the opportunity to refinance.

While the "Great Recession of 2008-2009" may be statistically nearing the end of its insidious run, its effects will be with us for a long time to come. The pain and suffering for employees is not over yet. Unemployment, which tends to peak after a recession has actually ended, is a lagging economic indicator. Currently at 9.5% unemployment, is expected to top 10% later this year and decline slowly in a tepid recovery. Nobel Laureate Paul Krugman warns of a jobless recovery. Some industries may never come back.

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Other Notes

When asked why it is taking so long for the economy to recover, Warren Buffett responded, "They're doing things on a lot of fronts. But you can't produce a baby in one month by getting nine women pregnant." Warren Buffett June 24, 2009

Buying a First House in 2009
The American Recovery and Reinvestment Act of 2009 provides for a tax credit of up to $8000 (10% of the purchase price up to $80,000) for qualified first-time home buyers. The purchase must be for a principal residence, and property must close during 2009. There are income limitations, with a phase-out for single taxpayers with incomes from $75,000 to $95,000 and for married couples with incomes from of $150,000 to $170,000.

Wealth Effect

(Continued from Page 1 Column 2)

The road ahead may not be entirely smooth. We expect slow economic growth, rising unemployment, increased savings, a modest increase in consumer spending, and in the longer term, inflation. We are beginning to see minimal improvement in housing sales, and the rate of plunging prices appears to be leveling off.

What about Inflation?

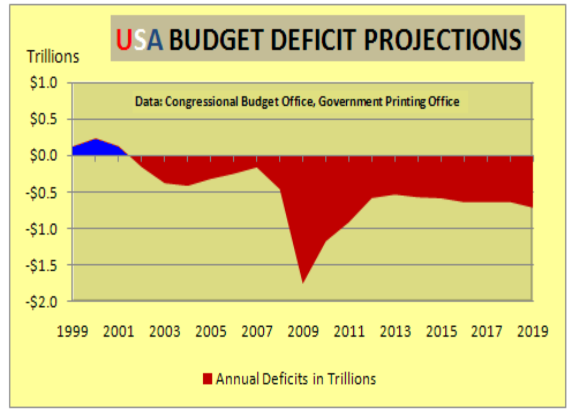
Inflation is like a money-eating termite. When left undetected, it will eat away at your purchasing power and erode your financial foundation. Consider that prices for consumer products as measured by the Consumer Price Index (CPI) have increased 28% during the past 10 years.

Over the past 18 months, the US government has undertaken the largest monetary policy response in history to recover from the near collapse of our financial system. The Fed, as well as Central Banks worldwide, has injected trillions of dollars into the market. Most of the funds have been used to shore up balance sheets of troubled banks and have not yet flowed into the general economy. Tighter credit restrictions and decreased borrowing from tapped-out consumers and businesses have kept these dollars from igniting demand for goods and services.

Inflation happens when too much money is chasing too few goods and services. Therefore, despite the massive increase in the supply of money, depressed consumer spending and increased savings rate have temporarily kept inflation at bay. The velocity of money, or the degree to which money changes hands, has slowed to a trickle.

In September, the major fear was that the financial system was about to collapse. The Federal Reserve aggressively created money, a move now viewed by most economists as having been both necessary and appropriate. However, we are concerned about the side effects of the government's heroic efforts and the inflationary impact once demand picks up.

The 2009 budget deficit is projected to be $1.8 trillion, three times as large as a year ago. This deficit set a record as the largest percentage share of GDP since 1940. With deficits projected out as far as 2019 (see graph following), foreign lenders now question both the long-term financial stability of the US and the dollar's role as the world's reserve currency.



Any reduction in the foreign demand for US Treasury securities can cause the dollar to depreciate if bond holders begin to sell US debt. As the dollar declines in value, the cost of foreign goods increases. This compounds the inflationary effect because the cost of imports rises.

For now, inflation looks stable, with CPI projected to rise by about 1% in 2009. For 2010 inflation is expected to be 2-3%. JP Morgan estimates that employee compensation is the single most important determinant of inflation. With unemployment at 9.5% and rising, companies continue to reduce payrolls by cutting both jobs and salaries. Until broad economic conditions improve, money will remain idle before flowing freely again.

Renewed inflation is likely, although when we will see it is unclear. There are investments which provide a hedge and help insulate portfolios against inflation. Adding positions in real assets like commodities or real estate and owning inflation-protected securities such as Treasury Inflation-Protected Securities (TIPS) are among the investment choices we use to protect against loss of purchasing power due to inflation.