



First Quarter 2009

Quarterly Investment Commentary

“Down markets ... are as inevitable as they are unpleasant. They are also finite.”

...Royce Funds

Weathermen tell us that spring (or more specifically, March) comes in like a lion and goes out like a lamb. The same could be said for financial markets this year as well. Stocks dropped significantly in January and February, on weak economic data and concerns about the current administration's ability to combat the credit crisis. But in March stocks experienced their best one-month gain in more than six years. The rally was a welcome relief, yet the quarter still ended with double-digit losses across the board. The S&P 500 Index rose nearly 9% in March, but finished the quarter with an 11% decline. The Dow Jones Industrial Average and Russell 2000 Index of small company stocks experienced similar jumps in March, but lost 12.5% and 15% for the quarter, respectively.

Overseas, the performance of stocks was about the same as here. Most European economies, which have been hit hard by the global recession, were down between 10% and 15% for the quarter. The only bright spot came from emerging market countries, such as China, Russia, and Brazil. Those markets rose modestly during the quarter – the MSCI Emerging Markets Index increased by 1.0% – but they have also fallen significantly more than our market over the past 12 months.

The Economy

The list of issues affecting today's investment landscape is dizzying, and the current recession in the U.S. is shaping up to become the longest since the 1930s. As expected, unemployment rose again in March, and the total number of job losses since the start of the recession now stands at 5.1 million. But the storm that has buffeted the economy and the financial system is starting to show the first signs of potentially subsiding. Better-than-expected (or less negative) data related to housing, retail sales, and durable goods have emerged in recent weeks. Additionally, several large corporate mergers and debt offerings have been announced or successfully completed, a sign that credit markets are beginning to thaw.

The Federal Reserve and U.S. Treasury have also announced new programs to stimulate the economy, restore confidence in the banking system, and loosen credit markets. Specifically, the Federal Reserve reiterated its commitment to hold interest rates at current low levels for “an extended period of time” and announced plans to purchase more than \$1 tril-

lion of mortgage-backed and Treasury securities. A week later, the Treasury Department released details on a new Public-Private Investment Program designed to help rid the banks of the toxic assets on their balance sheets.

Experts continue to debate whether the details of these plans are the most effective options. Economics is an inexact science, to be sure. But the larger story is the enormous amount of stimulus being injected into the economy and the apparent willingness on the part of policymakers to do whatever is necessary to lift our economy out of its current state.

On balance, we believe it's likely that the economy is past its recessionary low point. Economic growth will probably be "less negative" in the second half of this year, with a chance for positive growth by the end of 2009 or first-half of 2010. At the same time, it's important to remember that recoveries rarely proceed smoothly. The trends in month-to-month and quarter-to-quarter data tend to lurch forward and backward as the economy regains its footing. It's also unlikely that this recovery will be particularly strong. Past U.S. recoveries have typically been fueled by credit expansion. Growth this time is likely to remain pressured by ongoing credit issues and deleveraging in the financial sector and a focus on rebuilding savings – rather than on spending – by consumers.

The Market Outlook

So what, then, is the outlook for equities? It remains to be seen whether the March rally represents the beginning of a turnaround or merely a bounce from oversold levels. The recent market rally has been fueled, at least in part, by economic data suggesting that things might be less bad than expected. And some part of this rally is likely relying on the continuation of these "positive" surprises. These are thin reeds on which to form an investment hypothesis, and the clear risk is that if these trends reverse, so could investor's attitudes toward stocks.

That being said, there are reasons to be cautiously optimistic about the market. Stocks are trading at reasonable valuation levels once again, and there continues to be a record level of cash on the sidelines. A period of market stability will undoubtedly encourage some of this cash to shift into equities.

It's also worth pointing out that stocks have now retraced twelve years of gains; that is, in March the S&P 500 touched the same level it had been 12 years earlier. This is an incredibly rare event, having only occurred two other times in the past 100 years, once on April 8, 1932 and again on December 6, 1974. In 1932, reaching the 12-year low occurred three months before the end of the bear market. In 1974, it marked the exact end of the bear market. In both cases, the economy continued to contract beyond the bear market bottoms, as is typical.

The market in 2008 was the worst year for stocks since the 1930s, and the first few months of 2009 weren't much better. For this reason, many investors remain highly risk averse. Right now we appear to be in the midst of a bottoming process that began last October. (Remember, market bottoms are not events, they are processes). As such, we can expect ex-

citing rallies, as has occurred since the March 6th low, but also some painful pullbacks, especially if expectations advance ahead of economic reality.

Because corporate earnings growth is likely to be constrained coming out of this recession, we may remain stuck in a range, rather than moving into a new and persistent uptrend. Eventually, however, we believe that prices will grind their way higher over the next few years as the global economy improves. For these reasons, we look to opportunistically add to our equity and fixed-income exposure in client accounts on a gradual basis over the coming weeks and months in order to generate higher long-term returns. As always, our portfolio investment decisions will be based on balancing the risks and opportunities we identify.

Disclosure: Past performance is not indicative of future results. All indices are unmanaged and investors cannot invest directly into an index. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. The Nasdaq Composite Index measures all Nasdaq domestic and non-U.S.-based common stocks listed on the Nasdaq Stock Market. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The MSCI Emerging Markets Index is a market capitalization-weighted index composed of companies representative of the market structure of 26 emerging market countries in Europe, Latin America, and the Pacific Basin. The MSCI EAFE Index is a float-adjusted market capitalization index designed to measure developed market equity performance, excluding the U.S. and Canada.

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